FINANCIAL MARKETS LAW COMMITTEE

RESPONSE TO EUROPEAN COMMISSION'S CALL FOR EVIDENCE ON EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

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FINANCIAL MARKETS LAW COMMITTEE[1]

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1 Sonya Branch, Stephen Parker and Sean Martin took no part in the preparation or discussion of this response and it should not be taken to represent the views of the Bank of England, HM Treasury or the Financial Conduct Authority.

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1. INTRODUCTION

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

1.2. On 30 September 2015, the European Commission published a call for evidence on the EU regulatory framework for financial services (the "**Financial Services Consultation**"), which invites interested parties to provide feedback and empirical evidence on the benefits, unintended effects, consistency and coherence of financial legislation adopted in response to the financial crisis. The FMLC welcomes this initiative, informed as it is by the recognition that aspects of legal and regulatory uncertainty—including inconsistencies, gaps and unintended consequences—can act both to import excessive systemic risk and/or retard long-term investment and sustainable growth.

1.3. This is not the first occasion on which the organs of the European Union have demonstrated a concern for the coherence of EU financial services legislation. A similar review was undertaken in 2013 by the European Parliamentary Committee on Economic and Monetary Affairs ("**ECON**").[3] The FMLC responded to the ECON consultation in June 2013 (the "**ECON Response**") and some of the issues which the Committee raised at that time remain pertinent today. For ease of reference and for the sake of avoiding duplication, a copy of the response is appended to this paper.[4]

1.4. The FMLC has also written extensively on the subject of coherence in the field of international financial services legislation and regulation. In February 2015, the Committee published a discussion paper on "Coordination in the Reform of International Financial Regulation" (the "**G20 Discussion Paper**") which sought to engage international organisations, national authorities and regulators, governments, stakeholders, industry associations and academics in the inter-jurisdictional aspects of countries' implementation of G20 financial regulatory

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[3] The public consultation questionnaire was published on 14 March 2013. ECON's conclusions on the consultation and summary of the findings can be accessed here: http://www.europarl.europa.eu/document/activities/cont/201402/20140210ATT79138/20140210ATT79138EN.pdf.

[4] Also available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/300613.pdf.

reform commitments.[5] In an annex to the G20 Discussion Paper, the FMLC provided details of overlaps, inconsistencies and conflicts which have emerged between respective national rules; focusing on six key areas (derivatives, securitisation, capital, resolution, bank structural reform and data sharing). Significant input was received and an interim feedback statement was subsequently published.[6] The Committee, which has appointed a high-level Steering Group to carry work forward, will report this year with its recommendations. Meanwhile, much of the analysis undertaken in the G20 Discussion Paper, which compares regulation in the EU to regulation in the US and Japan, is relevant to the themes in the Consultation and in particular to the Commission's concern to identify rules that "may give rise to unintended consequences such as regulatory arbitrage". The G20 Discussion Paper and the interim feedback statement are both published on the FMLC website (www.fmlc.org).

1.5. On a similar theme, the FMLC co-authored a comment paper with the Committee for Capital Markets Regulation in September 2015 (the "**Joint Comment Paper**") which called for the mutual recognition of central clearing-counterparties as between the US and EU.[7] The Joint Comment Paper quoted a 2015 report by the European Securities and Markets Authority which noted that the current lack of mutual recognition put European clearing members and their subsidiaries at risk and created the potential for regulatory arbitrage between jurisdictions. The Joint Comment Paper is published on the FMLC website and the issues it raises are discussed further below.

1.6. Against this background of frequent and sustained engagement with the subject of the Commission's enquiry, the FMLC takes this opportunity to respond to the Financial Services Consultation.

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[5] The paper can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_g20_discussion_paper.pdf.

[6] See FMLC paper entitled "Interim Feedback Statement: FMLC Discussion Paper on Coordination in the Reform of International Financial Regulation", dated 21 September 2015. The paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_interim_feedback_statement_coordination_in_the_reform_of_international_financial_regulation.pdf.

[7] The Joint Comment Paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc-ccmr_joint_statement_1_september_2015.pdf/.

2. EXECUTIVE SUMMARY

2.1. The Financial Services Consultation observes that the pace of regulatory reform has been intensive in the years since the financial crisis and its immediate aftermath. It identifies "an international consensus to restore financial stability and public confidence" as the trigger for much of the rule-making that has taken place in Europe in the last six years. The Financial Services Consultation goes on to acknowledge that the volume of legislation put in place in so short a time may give rise to unintended consequences and inefficient barriers to market entry. It seeks feedback, in particular, on duplications, inconsistencies, regulatory gaps, loopholes and instances of inadequate enforcement.

2.2. The Financial Services Consultation covers four broad categories of problem and 15 sub-categories of situations which exhibit a lack of regulatory coherence. The four main categories are: 1) unnecessary regulatory constraints on financing; 2) unnecessary regulatory burdens; 3) interactions between rules, inconsistencies and gaps; and 4) rules giving rise to unintended consequences (including opportunities for arbitrage and pro-cyclicality risks). Of these, the first two categories do not fall within the FMLC's remit. The Committee has therefore addressed itself to the final two categories. Certain issues may, however, have features which mean that they also qualify as problems within either or both of the first two categories.

2.3. This response identifies areas in which one or more of the following types of inconsistency and gaps in European financial services legislation and regulation may be said to arise

- i) internal inconsistency within a piece of EU legislation (including inconsistency between Level 1 texts and Level 2 implementing measures);
- ii) inconsistency between EU legislation and national legal regimes; and
- iii) unintended effects arising from proposed or adopted EU legislation.

2.4. The sections below discuss a number of core areas of financial regulation in which these problems may arise:

- i) securitisation risk retention;
- ii) securitisation disclosure requirements;

iii) indirect clearing requirements;

iv) securities financing transactions;

v) bank recovery and resolution;

vi) central clearing and bank resolution; and

vii) benchmark reform.

3. SECURITISATION RISK RETENTION

3.1. Securitisation risk retention requirements—which restrict or prohibit investment in certain securities unless a proportion of the issued risk is retained by an entity responsible for bringing the securities to market—have, in the view of the FMLC, given rise to a number of unintended consequences and inconsistencies. These have been the subject of correspondence between the Committee and the Commission on a number of occasions since issues were first raised by the FMLC in 2012. On 30 September 2015, the Commission published a Proposal for a Regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation (COM (2015) 472, the "**Proposed Securitisation Regulation**" or, with the published preamble, the "**Proposal**"). The Proposed Securitisation Regulation would augment the European securitisation risk retention regime in the manner outlined below.

3.2. Existing European rules on securitisation risk retention are to be found, among other places, in Regulation No 575/2013/EU (the "**CRR**"), supplemented by Commission Delegated Regulation (EU) No 625/2014. These rules apply to credit institutions and investment firms. Article 405 of the CRR provides

> An institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5 %.

3.3. The rules place the onus on investor institutions to ensure that the risk retention requirements are satisfied. According to Articles 405 and 406 of the CRR, the

investor must satisfy itself as to the type of entity which retains an interest (originator, original lender or sponsor), the forms of retention used, the level of net economic interest retained and the assessment of the consolidated situation of the retaining entity. Similar rules for investment by alternative investment fund managers are set out in Article 17 of Directive 2011/61/EU on Alternative Investment Fund Managers (the "**AIFMD**") and supplemented by requirements set out in Article 51 of Commission Delegated Regulation (EU) No 231/2013. Rules for insurers and reinsurers can be found in Article 135 Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance ("**Solvency II**"), supplemented by Articles 254 to 256 of Commission Delegated Regulation (EU) No 35/2015; whilst those for UCITS are in Article 50a of Directive 2009/65/EC (the "**UCITS Directive**").

3.4. Collectively, these rules take the so-called "indirect approach" to risk retention: securitising entities are not directly subject to the requirements themselves but a prospective institutional investor is required to check, before investing, whether an appropriate entity (originator, original lender or sponsor) has retained sufficient risk. In contrast, the US regime has taken a "direct approach": section 941 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act requires that a "securitizer" (broadly covering the issuer or originator and the sponsor) of asset-backed securities must retain at least five percent of the credit risks for the assets collateralising the securities. On 23 July 2015, the Basel Committee on Banking Supervision ("**BCBS**") and the International Organisation of Securities Commissions ("**IOSCO**") published a report establishing international *Criteria for Identifying Simple, Transparent and Comparable Securitisations*. Criterion 12 on the "Alignment of Interest" specifies that

> In order to align the interests of those responsible for the underwriting of the credit claims or receivables with those of investors, the originator or sponsor of the credit claims or receivables should retain a material net economic exposure and demonstrate a financial incentive in the performance of these assets following their securitisation.

3.5. Criterion 11 specifies standards for the disclosure of information to investors.

3.6. On 10 October 2014, elements of a hybrid (direct-indirect) approach were introduced into the European risk retention requirements by two Commission Delegated Regulations in respect of the CRR (No 625/2014) and Solvency II (No 35/2015),

respectively. These regulations impose requirements on the originator, sponsor or original lender of a securitisation explicitly to disclose its commitment to risk retention in documentation supplied to investor institutions and require investors to satisfy themselves that the disclosure has been made.

3.7. The Proposal will, according to the preamble published by the Commission, address the deficiencies of the indirect approach—which "places a heavy burden on the investor"—by "imposing a direct risk retention requirement and a reporting obligation on the originator, sponsor or the original lenders".[8] It will also harmonise the risk retention requirement across all securitisations in contrast to the sector-by-sector approach taken in the existing regime.

3.8. Moves towards a unified, cross-sectoral regime for risk retention are welcomed by the FMLC, as are any efforts to align the European rules with international principle and reduce discrepancies with other, third country regimes. The precise intended effect of the new legislation, however, is somewhat difficult to ascertain with respect to the existing obligations on investors.

3.9. Articles 23 to 27 of the Proposed Securitisation Regulation provide for the amendment and repeal of various provisions of the laws listed in paragraph 3.3 above. In particular, they provide for the repeal in the AIFMD, Solvency II and UCITS Directive of articles which require the Commission to adopt implementing measures laying down the requirements that must be satisfied "in order for [the investor] to invest". (They do not, however, provide for the repeal or amendment of Articles 405 to 407 of the CRR. Rather, these latter articles, which apply equivalent restrictions on investment in securitised products by credit institutions and investment firms and place the onus on the investor institution to carry out due diligence, will be repealed under a parallel proposal for a Regulation amending the CRR.[9] The preamble to the Proposed Securitisation Regulation also stipulates, at page 17, that further amendments to delegated acts under the CRR and Solvency II will be forthcoming and it recognises the need to ensure that any amendments yet to be proposed harmonise with the definitions and standards introduced by the Proposed Securitisation Regulation.)

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8 See section on risk retention (Article 4) on page 14 of the Proposal.

9 Proposal for a Regulation amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, dated 30 September 2015, COM (2015) 472 final.

3.10. As a result of these changes, the language of restriction and what investors are "allowed to invest in" has been removed from AIFMD, Solvency II and UCITS Directive and has been substituted with language in the Proposed Securitisation Regulation which stipulates that institutional investors must "verify" that "the originator, sponsor or original lender *retains a material net economic interest* … and discloses it" (emphasis added) and that the investor does so "before becoming exposed" to a securitisation under Article 3. It is unclear to what extent this language is intended to reinforce and bolster the existing indirect approach—as a supplement to the new, direct approach—by requiring the institutional investor to look behind the securitising entity's disclosure of its retained interest and, in effect, guarantee appropriate levels of risk retention by the originator, sponsor or original lender. In this regard, the approach taken in Articles 405 and 406 of the CRR, which is considered to exemplify the existing indirect approach, is more practical in that it stops short of placing an obligation on the investor to guarantee the risk retention outcome. Article 405 restricts investment to securitisation in which the securitising entity has "explicitly disclosed" its retained interest and Article 406 places the onus on the investor to have a "thorough understanding" of the information disclosed.

3.11. On one point, the Proposal is very clear: "[t]here is no intention to undo what has been put in place in the EU to address the risks inherent in… risky securitisation". Thus the general requirement for securitising entities to retain 5% net economic interest in securitised products has been preserved across the board. While it makes no comment as to matters of policy, the FMLC understands that the strict application of the existing European securitisation risk retention requirements has had a detrimental effect on the European market in collateralised debt obligations ("**CLOs**") and has caused it to decline significantly—a decline which is also reflected in published statistics.[10] In a letter to the European Commission dated 29 May 2015, the FMLC drew attention to these unintended consequences of the legislation which, some may argue, also represent an unnecessary constraint on financing and on market liquidity.[11]

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10 For example, see the table on page 13 of the Loans Syndications and Trading Association ("LSTA") 2013 publication entitled "Risk Retention and CLOs", available on the Federal Deposit Insurance Corporation website at https://www.fdic.gov/regulations/laws/federal/2013/2013-credit_risk_retention-staff_10-supp.pdf. The LSTA notes that "European CLO formation collapsed, due in large part to the risk retention rules".

11 FMLC letter entitled "Issues of Legal Uncertainty Arising in the Context of Securitisation Disclosure Requirements", 29 May 2015. The letter is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_securitisation_disclosure_paper.pdf.

3.12. Previously, in an earlier letter to the European Commission, which was also sent to the European Banking Authority ("**EBA**"), dated 7 November 2012, the FMLC had outlined issues of uncertainty in the application of this same securitisation risk retention requirement—in particular as to the definitions of "originator", "original lender" and "sponsor"—to CLOs.[12] The question at issue in the earlier letter was whether parties to CLOs could safely rely on a flexible interpretation put forward by the Committee of European Banking Supervisors ("CEBS"), a predecessor body to the EBA. Subsequently, the FMLC engaged with the EBA on this issue in the context of a consultation (EBA/CP/2013/4) on draft technical standards implementing the CRR. In the course of finalising these technical standards (the "**RTS**"), the EBA rejected the flexible interpretation, thereby giving rise to discontinuity in the European regulatory approach to this issue and exacerbating the unintended consequences identified in the paragraph above. The Proposal adopts the definitions of "originator", "original lender" and "sponsor" set out in the CRR without any separate consideration of the CLO markets and follows a recommendation by the EBA to close "a potential loophole" by "excluding shelf companies" from the definition of "originator" for the purposes of Article 4. It does not, therefore, address the issues previously raised by the FMLC. The Committee continues to believe that the flexible interpretation had merit and would have assisted in avoiding the unintended consequences outlined above. In the letter dated 7 December it proposed, as an alternative, that the definition of "sponsor" be expanded so as to include non-banks.

3.13. A related point was raised in the G20 Discussion Paper (at page 38) where attention was drawn to the fact that, as between the rules applying in the US and the EU, the securitising entities are defined differently and, as a consequence, the risk retention requirement is imposed on different categories of entity. The "securitizer" under the Dodd-Frank Act does not always fall within the definition of the originator, sponsor or original lender under the CRR and *vice versa*. This may entail that, for some securitisations where the issued securities are intended to be sold in both regions, risk has to be retained by multiple entities or by an entity which is not the most efficient risk retainer and would otherwise not be chosen by the arrangers of the

[12] The letter is available upon request. Please contact the FMLC Secretariat (at the following email address: contact@fmlc.org). The letter is referred to in the FMLC publication entitled "Letter to the European Commission in Response to the Capital Markets Union Green Paper and Related Securitisation Consultation Paper", dated 29 May 2015. This letter is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_mr_jonathan_faull_(european_commission).pdf .

securitisation in either jurisdiction. This inconsistency acts as an unnecessary constraint on financing in the cross-border securitisation markets.

3.14. The G20 discussion paper also highlights (at page 38) certain exemptions from risk retention requirements which vary across jurisdictions and which may offer the opportunity for international arbitrage. The Proposal identifies (at page 3) that the different characteristics of the US and EU securitisation markets—including the role of public sponsorship and exemptions for securitisations backed by public guarantees—may have contributed to the stronger recovery of the US markets following the financial crisis. The FMLC observes that transactions in the US also benefit from an exemption for asset-backed securities that are collateralised exclusively by "qualified residential mortgages". There is no such exemption available in the EU—although covered bonds remain outside the EU securitisation framework—which may be expected to reduce liquidity in the EU securitisation markets vis-à-vis the US markets.

3.15. In section 3 of the ECON Response, appended to this paper, the FMLC identified a number of definitional and linguistic inconsistencies as between existing risk retention rules in EU legislative instruments. In the view of the FMLC, there was no clear rationale for these inconsistencies and their effect has been to create uncertainty as to the applicability and effect of the rules. By introducing cross-sectoral definitions for investment in securitised products, which apply to all institutional investors, the Proposed Securitisation Regulation would go some considerable way towards addressing the FMLC's concerns and the Proposal is, on that account, to be welcomed.

4. SECURITISATION DISCLOSURE REQUIREMENTS

4.1. In a detailed paper published in May 2015 (the "**Securitisation Disclosure Paper**"), the FMLC drew attention to the multiplicity of disclosure regimes applicable to securitisations in the EU and recommended the rationalisation of those regimes and the establishment of a single repository for regulatory disclosures. The paper acknowledged the work done by the Joint Committee of the European Supervisory Authorities ("**ESAs**") in regard to the rationalisation of disclosure requirements and their report published on 12 May 2015[13] but concluded that, because the report

[13] The report can be accessed here: https://www.eba.europa.eu/documents/10180/950548/JC+2015+022+-+Final+JC+Report+on+securitisation.pdf.

focused primarily on a lack of harmonisation in due diligence requirements for institutional investors (referred to above), it did not wholly address the practical problems faced by securitising entities in complying with disclosure requirements.

4.2. In a significant step forward, the Proposed Securitisation Regulation collates European securitisation specific transparency requirements in one, cross-sectoral piece of legislation. It confers a mandate on ESMA, in close cooperation with the other ESAs, to develop standardised templates for the disclosure of the required information and it requires, in Article 5, that the originator, sponsor and issuer (i.e. "securitisation special purpose entity" or "SSPE") delegate the day-to-day task of making freely available the requisite information on a website meeting certain specified criteria to one entity. These latter provisions will, in practice, says the preamble, allow the reporting of information to a single data repository such as the "European Datawarehouse". These proposals are in line with the core recommendations of the Securitisation Disclosure Paper, which urged the EU to move towards a single standard for transparency and disclosure requirements and to facilitate the consolidation of information relating to each transaction in a single location. The Committee therefore views this aspect of the Proposal as a welcome step to resolve overlaps and inconsistencies. It should be noted, however, that transparency requirements in respect of securities offerings generally and those established by central banks for eligible collateral are also crucial for securitisations and these may have slightly different requirements or use slightly different data reporting templates, as observed in the Securitisation Disclosure Paper. Every effort should be made to align the final forms of the standardised data reporting templates which will be developed by the ESAs with the requirements of more general securities legislation such as the Prospectus Directive and Transparency Directive as well as with the data templates used by, for example, the European Central Bank and the Bank of England.

5. INDIRECT CLEARING REQUIREMENTS UNDER EMIR and MiFIR

5.1. Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") introduced provisions to increase the resilience of the OTC derivatives market and to reduce systemic risk by introducing a mandatory clearing requirement for OTC derivatives. Article 4 of EMIR contemplated that counterparties would fall within the terms of the new regime either as clearing

members, or as clients of clearing members or through indirect clearing arrangements with clients of clearing members. Article 4(4) empowered ESMA to develop technical standards for indirect clearing arrangements which could comply with the regime. The result was Commission Delegated Regulation (EU) No 149/2013 on indirect clearing arrangements.

5.2. A year later, Regulation (EU) No 600/2014 ("**MiFIR**") previewed the introduction of regulatory requirements for indirect clearing services in respect of exchange traded derivatives ("**ETDs**"). Article 30 conferred a mandate on ESMA to develop technical standards for the indirect clearing of ETDs and draft standards were first the subject of a consultation by ESMA in December 2014 (the "**Indirect Clearing CP**").[14]

5.3. Subsequently, on 5 November 2015, ESMA published draft regulatory technical standards under cover of a second consultation paper (No. 2015/1628, the "**Indirect Clearing RTS**") concerning the implementation of indirect clearing arrangements for: (i) OTC derivatives under EMIR—ESMA proposed to revise the rules adopted in 2013; and (ii) ETDs under MiFIR.

5.4. The FMLC responded to the Indirect Clearing RTS in December 2015 (the "**December 2015 Paper**"),[15] suggesting that uncertainty could arise if the requirements of the proposed technical standards were to come into conflict with the national insolvency laws of either third countries or EU Member States.[16] In particular, the FMLC was concerned that third country insolvency laws which invalidate a transfer of property away from an insolvent entity[17]—in this case the

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14 Consultation Paper (2014/1570) on the implementation of the Markets in Financial Instruments Directive (2014/65/EU) and MiFIR. The consultation paper can be accessed here: https://www.esma.europa.eu/mwg-internal/de5fs23hu73ds/progress?id=dkYcklZmO9HoXFdC6IwwKuAbs1WyDQHecpR8ua7ttUc,.

15 The consultation paper can be accessed here: https://www.esma.europa.eu/system/files_force/library/2015/11/20151628__consultation_paper_on_indirect_clearing_under_emir_and_mifir.pdf?download=1.

16 This issue was first raised by the FMLC in a paper published in October 2015 Paper. For more information on specific insolvency rules with which the provisions of the proposed technical standards would conflict, see section 3 of that paper, available at:http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_indirect_clearing.pdf.

17 For example, the "anti-deprivation" principle—replicated in several of the legal systems of the Commonwealth—can operate to invalidate any contractual term which stipulates that property owned by a debtor will be removed from its estate in the event of its insolvency. The principle, which applies equally to personal and corporate insolvency, has been summarised in English case law as follows:

> [A] simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of bankruptcy should go over to someone else and be taken away from his creditors is void as being a violation of the policy of bankruptcy laws (James LJ, *Ex parte Jay: In Re Harrison* (1880) 14 Ch D 19.25).

defaulting client—might conflict with a proposed requirement for "leapfrog payments", whereby a clearing member is required to make repayments of collateral and other payments arising from a position, which would otherwise be paid to a direct client, to an indirect client in the event of a default by the direct client. These concerns had also been raised with ESMA by the FMLC and other stakeholders in response to the Indirect Clearing CP.[18] The concerns—and the measures proposed by ESMA to address them—are the subject of extensive analysis in the December 2015 Paper, which takes into account the direct effect of MiFIR and EMIR and the priority of these regulations over the laws of EU Member States. In the view of the FMLC, proposed technical arrangements for indirect clearing may—the direct effect of the Level 1 regulations notwithstanding—prove to be inconsistent with the national insolvency laws of both third countries and EU Member States in such a way as to give rise to conflicts of laws issues and detrimental legal uncertainty. The December 2015 Paper is appended hereto for ease of reference.

6. SECURITIES FINANCING TRANSACTIONS

6.1. On 10 February 2015, the FMLC wrote to the European Commission to express a concern that restrictions on rights of rehypothecation introduced in Article 15 of the Commission's Proposal for a Regulation on the reporting and transparency of securities financing transactions were inconsistent with Member States' property laws and, in particular, the legal nature of a title transfer financial collateral arrangement.[19]

6.2. The FMLC therefore greatly welcomes amendments to the proposed Article 15 which appear in Regulation (EU) 2015/2365 on transparency of securities financing transactions and of reuse (now adopted) and which have been introduced better to reflect the nature of title transfer collateral arrangements.

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18 FMLC paper entitled "Uncertainty Arising in the Context of Indirect Clearing of Exchange Traded Derivatives under the Markets in Financial Instruments Regulation", 16 October 2015. The paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_indirect_clearing.pdf.

19 The letter to the European Commission on a Proposal for a Regulation on Reporting and Transparency of Securities Financing Transactions is available here: http://www.fmlc.org/uploads/2/6/5/8/26584807/_fmlc___up___11455326_v_1_letter_to_mr_jonathan_faull_on_the_proposed_regulation_on_securities_financing_transactions.pdf.

7. BANK RECOVERY AND RESOLUTION

7.1. Following the publication of a Proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms by the European Commission in June 2012, the FMLC engaged on several occasions with the legislative text as it developed. In particular, the Committee published papers in February and October 2013 addressing, *inter alia*, conflicts of law issues concerning proposals to allow resolution authorities to override or suspend certain contractual provisions in financial instruments.[20]

7.2. Since the publication of Directive 2014/59/EU (the "RRD"), in the Official Journal in June 2014, the FMLC has corresponded on several occasions with the UK authorities in an effort to address residual legal uncertainties in the RRD in the course of the national implementation of the directive. In September 2014 the FMLC published a paper raising, *inter alia*, issues concerning proposals for implementing bail-in.[21] In August 2015, the FMLC wrote to the Prudential Regulation Authority in the context of a consultation on contractual stays of termination rights in financial contracts governed by third-country law and, in October 2015, the FMLC addressed two letters to HM Government concerning the interaction of bail-in with the English law of set-off and the potential impact on financial contracts of publicity surrounding the appointment of a temporary administrator as contemplated by Article 29 of the RRD.[22] The FMLC is concerned that several of the issues raised in these publications reflect gaps in the RRD. (Related issues are also raised in the section below, in relation to central clearing and the definition in the RRD of "central counterparty".)

7.3. Article 71 of the RRD provides for resolution authorities to be invested with a power to suspend "the termination rights of any party to a contract with an institution

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[20] On 5 February 2013 the FMLC published a paper entitled "Banking Reform (Ring-Fencing)". The paper can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/175b.pdf. On 10 October 2013 the FMLC published a paper entitled "Further Discussion of Legal Uncertainty which could Arise from Ring-fencing Proposals: an Addendum to the FMLC Paper Entitled Banking Reform (Ring-fencing)". The paper can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/175.pdf.

[21] FMLC paper entitled "Response to HM Treasury's Consultation Paper on the Transposition of the Bank Recover and Resolution Directive", dated 24 September 2014 (the paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/response_to_hmts_consultation_paper_on_transposing_the_brrd.pdf.

[22] The FMLC sent two letters to HM Treasury on 6 October 2015: (i) a letter on the appointment of a temporary administrator as provided for in Article 29 of the Bank Recovery and Resolution Directive (the letter can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/_fmlc___up__11677574_v_1_fmlc_letter_on_temporaryadministrators.pdf); and (ii) a letter examining set-off under the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014, which can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/_fmlcup11677328_v_8_fmlc_letter_on_set-offamended_.pdf.

under resolution" but the RRD does not have sufficient extra-territorial reach to guarantee that a suspension of this kind will be recognised by the courts of a third country legal system, which raises conflicts of law issues that may be particularly acute where the legal system in question is also the governing law of the contract. The FMLC commented on this potential problem in two papers published in 2013 on the Commission's proposal for a directive.[23] Since then, the problem has been addressed to some extent by valuable international work, initiated by the FSB, to secure market participants' adoption of contractual terms recognising such a "stay". Following on from this work, Member States' regulators have promoted initiatives to secure widespread contractual recognition of resolution stays.[24] It is in this context that definitions in the RRD definitions and the terms which circumscribe the scope of a resolution authority's power to impose a discretionary stay have given rise to uncertainty.

7.4. One instance of this uncertainty is the inconsistency between Recital 94 and Article 71, both of which refer to a suspension of termination rights. Recital 94 stipulates that what may be required are "proportionate restrictions on counterparties' rights to close out, accelerate or otherwise terminate *financial* contracts" (emphasis added) but Article 71 itself confers a power to suspend termination rights in respect of all contracts, not merely financial contracts (although a record keeping obligation in Article 71(7) applies only to financial contracts). To the extent that positive obligations are now being imposed on firms by competent authorities to adopt contractual clauses recognising any resolution stay that may be imposed, this inconsistency creates uncertainty as to the scope of the obligation to adopt contractual clauses that may be required to match the scope of the power to impose a stay. Furthermore, the definition of "financial contracts" given at Article 2(100) of the RRD exacerbates this confusion in that it is defined inclusively by reference to examples of financial instruments but apparently non-exhaustively so as to create uncertainty about the status of contracts not included in the list of examples. The

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23 FMLC paper entitled "Discussion of Certain Legal Uncertainties Arising from the Council General Approach tp the Commission Proposal for a Recovery and Resolution Directive", dated 25 October 2013. The paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/149.pdf. See also FMLC paper entitled "Discussion of Certain Legal Uncertainties Arising from the Proposal for a Recovery and Resolution Directive", dated 18 February 2013. The paper is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_149_fmlc_paper_february_2013.pdf.

24 For example, see Prudential Regulation Authority Consultation Paper entitled "Contractual stays in financial contracts governed by third-country law", dated May 2015. The consultation paper is available at: http://www.bankofengland.co.uk/pra/documents/publications/cp/2015/cp1915.pdf.

FMLC would welcome clarification as to the classes of contract which may be the subject of a suspension of termination rights under Article 71.

7.5. A similar issue is raised by Article 55(1) (*Contractual recognition of bail-in*) which, broadly, introduces a requirement that firms entering into agreements governed by the law of a third country adopt terms recognising that liabilities under the agreement may be subject to bail-in. "Liability" is not defined in the article or the directive and thus—save for liabilities excluded from an exercise of the bail-in tool under Article 44(2), to which Article 55 is expressed not to apply—this requirement *prima facie* applies to all classes of liability, including operational liabilities, trade finance liabilities and liabilities to infrastructure providers (see below for a similar point in respect of contractual recognition of resolution stays in contracts with central clearing counterparties). To the extent that firms are thereby required to adopt contractual recognition clauses in contracts for these latter classes of liability, this would appear to be an unintended consequence of the article's provisions. Article 55(3) appears to acknowledge the need to narrow the scope of Article 55(1) and the categories of liability to which it applies. This provision requires the EBA to develop draft regulatory technical standards further determining the list of excluded liabilities. On 3 July 2015, the EBA published draft standards pursuant to this provision but stipulated that it would not propose any new grounds for exclusion or any new forms of liability to which the requirement would not apply because the creation of new exclusions would involve changing an essential element of the Level 1 text.[25] Therefore, the legal uncertainty arising from the apparent unintended consequences persists.

7.6. A different issue is raised by Article 29, which contemplates the appointment of a temporary administrator as an early intervention measure, before a bank or investment firm enters resolution. Article 29(1) requires the competent authority which appoints the temporary administrator to make the appointment public. The FMLC noted, in a letter to HM Government in October 2015, that publicity around the appointment of a temporary administrator could potentially trigger termination rights in financial contracts which would otherwise be suspended or, possibly, modified, when the bank enters resolution. To that extent, the requirement for

[25] See European Banking Authority Final Report on Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of Directive 2014/59/EU, dated 3 July 2015, p.4. The Final Report is available at: https://www.eba.europa.eu/documents/10180/1132911/EBA-RTS201506+RTS+on+Contractual+Recognition+of+Bail-in.pdf.

publicity appears to run counter to some of the objectives for which the RRD confers resolution powers on resolution authorities.

7.7. Also in a letter to HM Government in October 2015, the FMLC addressed the issue of depositor bail-in and set-off. The RRD does not automatically exclude non-guaranteed deposits from the scope of the bail-in tool. The FMLC is concerned that, in the event of a resolution, there may be uncertainty as to the impact of depositors' non-insolvency rights of set-off—for example, rights to set-off a balance held on deposit against a mortgage liability—in the event that deposits are bailed-in. In the view of the Committee, this uncertainty and the likelihood that it may have to be addressed through the "no creditor worse off" safeguard in Article 73(b) could increase the complexity of a resolution.

8. CENTRAL CLEARING AND BANK RESOLUTION

8.1. As mentioned in the section above, the RRD provides for resolution authorities to be invested with a power temporarily to suspend termination rights but not where those rights are held by "central counterparties" (Article 71(1), (2) and (3)). Such statutory resolution stays are becoming more prevalent across the globe but they raise significant conflicts of law questions wherever there is a risk that a stay in the resolution forum will not be recognised by the governing law of the contract. Regulators have, therefore, promoted initiatives to secure widespread contractual recognition of resolution stays.

8.2. Although statutory resolution stays are becoming more widespread, it is generally accepted that, in the context of derivatives clearing, they cannot apply to termination rights exercisable by a central clearing counterparty ("**CCP**") against a clearing member. This is because any regulatory requirement that might negatively affect a CCPs ability to terminate, value and close out an exposure could import systemic risk in view of the CCP's role as critical market infrastructure.

8.3. In the EU, some jurisdictions have implemented the resolution stay provisions of the RRD in such a way as to distinguish between those third country CCPs which are

recognised by ESMA for the purposes of EMIR and those which are not.[26] In such cases, third country CCPs which are not recognised are not excluded from the operation of a resolution stay. The third country legal systems which govern the CCPs' operations are, however, highly unlikely to recognise any resolution stay which applies to local CCPs. This inconsistency potentially gives rise to a conflicts of law problem and to unintended consequences.

8.4. This situation has come about in part because of legal uncertainty about the intended ambit of the relevant exclusion for "central counterparties" from the stay provisions in the RRD, where the term is not defined.[27] And it has been highlighted by proposals for regulatory requirements requiring authorised firms to negotiate clauses recognising resolution stays with third country CCPs which have not been recognised under EMIR.[28]

8.5. In the Joint Comment Paper, the FMLC and the Committee on Capital Markets Regulation expressed concern about this situation and observed that the uncertainty was particularly acute in the case of US CCPs, given the high volume of business which they undertake for EU clearing members. The Committees concluded that a positive equivalence decision by the European Commission vis-à-vis the US and the consequential recognition of US CCPs by ESMA for the purposes of EMIR would significantly ameliorate the situation.

9. BENCHMARK REFORM

9.1. On 18 of September 2013, the European Commission published a proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts (COM 2013/0641 final) ("the **Proposed Benchmark Regulation**"). The

[26] In the UK, for example, under section 70C of the Banking Act 2009, the Bank of England may suspend the rights of any party who is not an "excluded person". Section 70D defines "excluded person" so as to include a recognised central counterparty, EEA central counterparty or third country central counterparty but a "third country central counterparty" must (by virtue of section 285 of the Financial Services and Markets Act 2000) be a recognised CCP under Article 25 of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR").

[27] A recital unconnected to the stay provisions refers to "central counterparties as defined by [EMIR]". "Central counterparty" is not a defined term in EMIR but "CCP" is defined and used (e.g. in Article 25) in such a way as to make it clear that it applies all CCPs not just recognised CCPs.

[28] In the UK, for example, the Prudential Regulation Authority has proposed (in a May 2015 Consultation Paper: CP19/15) a rule which would prohibit firms from creating new obligations or materially amending an existing obligation under a financial contract (as defined) without counterparty agreement recognising a resolution stay. The proposed rule would rely on the definition of "excluded person", *supra* n.26, which distinguishes between recognised and non-recognised third country CCPs.

FMLC has engaged with this proposal on several occasions to raise concerns about the unintended consequences to which it might give rise.[29] On 25 November the European Commission announced that a political deal had been reached on the Proposed Benchmark Regulation and that a final text would be produced. This was published on 4 December 2015 (the "**Final Draft Benchmark Regulation**").[30]

9.2. Among the FMLC's several comment letters and papers, one, dated 16 November 2015, addressed the possible unintended effects of the Proposed Benchmark Regulation in the context of foreign exchange ("**FX**") rate sources. The letter highlighted issues of legal uncertainty with particular reference to non-deliverable forward ("**NDF**") contracts referencing emerging markets currencies ("**EMCs**").

9.3. In that letter, the FMLC noted, *inter alia*, that there may be little or no choice as to the published rate sources available for specified EMCs, particularly in the case of relatively illiquid currencies and that published commercial/industry and indicative survey rates would *prima facie* fall within the scope of the Proposed Benchmark Regulation. The Committee also noted that some published indicative survey rates would be used as contractual fall-backs for when the primary rate or rates are not available. Because non-primary rates are only intended to be relied upon as a fall-back when other benchmarks are unavailable, said the FMLC, the methodological architecture is calibrated to the circumstances under which they may be activated.

9.4. The Committee was concerned that those deemed to be the administrators of primary and non-primary FX rates for EMCs would be unable to meet either (i) the proposed standards for administering benchmarks in the EU; (ii) the tests for equivalence in Title V of the Proposed Benchmark Regulation; or (iii) the threshold test for recognition by ESMA, with the unintended consequence that supervised entities would be prohibited from using FX rate sources.

9.5. Subsequently, the Final Draft Benchmark Regulation introduced new categories of benchmark as a refinement to the overall regulatory approach. These are listed in Article 3: "critical benchmark", "significant benchmark" and "non-significant

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29 The FMLC sent a letter to the European Commission dated 3 March 2015. The letter is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_european_commission_on_benchmark_reform.pdf. The FMLC also published a paper on 18 March 2014 entitled "Discussion of Legal Uncertainty Arising from the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts" which can be accessed here: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_issue_177_benchmark_reform_paper_2014_12.pdf.

30 The Final Draft Benchmark Regulation can be accessed here: http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf.

benchmark". The burden of regulation introduced is somewhat reduced in the case of a "significant benchmark" and very considerably reduced in the case of a "non-significant benchmark". The FMLC has not yet had the opportunity fully to assess the Final Draft Benchmark Regulation but it takes the view that the changes introduced by that text are likely to ameliorate some of the difficulties which the FMLC had identified.

10. CONCLUSION

10.1. The FMLC welcomes the Financial Services Consultation which invites interested parties to provide evidence and feedback on interactions, inconsistencies and gaps in the framework of EU financial services legislation and on the unintended consequences thereof.

10.2. The paragraphs above contain several examples of situations in which the FMLC has drawn attention to inconsistencies, gaps, overlaps and unintended consequences in the context of the Commissions' legislative proposals and these have subsequently been addressed, in whole or in part. The FMLC welcomes this responsiveness on the part of the Commission and its willingness to address clear instances of potential legal uncertainty.

10.3. Nevertheless, a few examples of issues within the FMLC's remit and the Financial Services Consultation remain to be addressed. This paper identifies these issues and draws them to the attention of the European Commission so that they can be considered and, where feasible, resolved.

APPENDIX 1 – RESPONSE TO CONSULTATION ON ENHANCING THE COHERENCE OF EU FINANCIAL SERVICES

June 2013

FINANCIAL MARKETS LAW COMMITTEE

Response to the European Parliament Committee on Economic and Monetary Affairs' Public Consultation on enhancing the coherence of EU financial services legislation

www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

Response to the European Parliament Committee on Economic and Monetary Affairs' Public Consultation on enhancing the coherence of EU financial services legislation

This paper has been produced by the Financial Markets Law Committee (the "FMLC") Secretariat, under the supervision of Joanna Perkins (FMLC Director) and a sub-committee of the FMLC comprising Kate Gibbons, James Grand and Ed Murray.[1]

[1] The FMLC is grateful to Jennifer Enwezor, Joshua Mangeot, Sherine el-Sayed and Roland Susman of the FMLC Secretariat for their assistance with drafting this paper.

1. INTRODUCTION

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

1.2. On 14 March 2013, The European Parliamentary Committee on Economic and Monetary Affairs (the "**ECON Committee**") launched a public consultation on enhancing the coherence of EU financial services legislation. In response to that consultation, the FMLC has prepared this paper setting out various areas where it has identified one or more of the following types of incoherence or inconsistency:

(i) internal incoherence or inconsistency within a piece of EU legislation (including inconsistency between Level 1 texts and Level 2 implementing measures);

(ii) incoherence, inconsistency or overlap between different pieces of EU legislation;

(iii) instances of incoherent or inconsistent implementation by individual Member States (each, a "**Member State**"); and/or

(iv) incoherence with—or inconsistency between—EU legislation and national legal regimes.

2. SUMMARY

2.1. This paper sets out instances of incoherence or inconsistency which the FMLC has identified in the following legislative areas:

(i) Risk retention requirements under: Directive 2006/48/EC, as amended by Directive 2009/111/EC ("**CRD II**"); the forthcoming Capital Requirements Regulation ("**CRR**");[2] Directive 2011/61/EU ("**AIFMD**"); Directive 2009/138/EC ("**Solvency II**"); and Directive 2009/65/EC (the "**UCITS Directive**"), as amended by the AIFMD.

[2] 2011/0202(COD). Political agreement was reached on the CRR on 26 March 2013.

(ii) The use of netting-related terms in the Commission proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (the "**RRD**")[3] and the existing *acquis*.

(iii) The meaning of "acting in concert" in Directive 2007/44/EC (the "**Acquisitions Directive**").

(iv) The rules for determining the location of assets in Regulation 1346/2000 (the "**Insolvency Regulation**"), which rules are proposed to be amended by an amendment Regulation published by the European Commission (the "**Commission**") on 12 December 2012 (the "**Amendment Regulation**").[4]

(v) The civil liability of credit rating agencies under Regulation 462/2013 ("**CRA III**").

(vi) The civil liability of custodians under the proposals to amend the UCITS Directive ("**UCITS V**").[5]

(vii) European Parliament proposals to amend the Market Abuse Regulation ("**EP MAR**")[6] and Commission proposals for a recast Directive on markets in financial instruments ("**MiFID II**")[7], as those proposals pertain to algorithmic and high frequency trading.

(viii) Client asset protections under Directive 2004/39/EC ("**MiFID**") and the proposed RRD.

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3 COM(2012) 280/3.

4 COM(2012) 744 final.

5 2012/0168 (COD). The Commission proposal was published on 3 July 2012 (COM(2012) 350 final); a Presidency Compromise Text (16902/12) was published on 11 December 2012.

6 Final Report of the Committee on Economic and Monetary Affairs of the European Parliament, dated 22 October 2012 (2011/0295(COD)).

7 Commission Proposal dated 20 October 2011 (2011/0298(COD)).

3. RISK RETENTION REQUIREMENTS

3.1. The FMLC considers that risk retention requirements—which restrict investment in securitisations[8]—provide examples of inconsistency across EU legislation and also between the relevant Level 1 text and Level 2 implementing measures.

3.2. Rules for credit institutions currently are found in CRD II but these will soon be superseded by rules in the CRR, which will also apply to investment firms.[9] Rules for alternative investment fund ("**AIF**") managers are in the AIFMD and a delegated Regulation pursuant to it ("**AIFMD Level 2**").[10] Rules for insurers and reinsurers are in Solvency II, whilst those for UCITS are in the UCITS Directive (as amended by the AIFMD).

3.3. The FMLC believes that the language of the risk retention legislation reflects numerous inconsistencies—for example:

(i) The CRR restricts the circumstances in which a party (an investment firm or credit institution) may be *exposed to the credit risk* of securitisation, whereas the other pieces of legislation listed above restrict the circumstances in which a party (*e.g.*, an AIF, insurer or UCITS) may *invest in* a securitisation.

(ii) The CRR restrictions apply to "securitisation positions", whilst those under the AIFMD and Solvency II apply to "securities or other financial instruments"[11] and to "securities or instruments", respectively.

(iii) The AIFMD presents an "originator" as an alternative to the concept of a firm that repackages loans into tradable securities. By contrast, Solvency II and the UCITS Directive define an "originator" as a firm that repackages loans into

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[8] The EU risk retention regime requires, first, that certain entities responsible for bringing financial instruments to market assume exposure to those same instruments and, second, that other specified entities invest exclusively in financial instruments which comply with the first requirement.

[9] Article 122a of CRD II. Cf. CRR, Articles 394 to 399. Given that CRD II will cease to apply soon, this paragraph does not consider that Directive further.

[10] (EU) No 231/2013.

[11] The AIFMD does not define "securities". "Financial instrument" is defined, at Article 4(1)(n), by reference to Section C of Annex I, MiFID. The UCITS Directive uses the same wording as the AIFMD. It defines "transferable securities" at Article 2(1)(n)(i).

tradable securities or other financial instruments.[12] The CRR definition of "originator" is different again and refers to an entity involved in the creation or purchasing of the obligations underlying the securitisation.[13]

(iv) Solvency II mandates the Commission to make rules implementing its risk retention provisions, which include a requirement that the *originator* retains a 5 per cent. interest. By contrast, the AIFMD and the UCITS Directive each mandate that rules shall be made that include a requirement that the *originator, the sponsor or the original lender* retain a 5 per cent. interest.

3.4. There is no clear rationale for these inconsistencies but their effect is to create uncertainty as to the applicability and effect of the rules. Consistency—and certainty—would be increased were the relevant provisions to be harmonised across the legislation.

3.5. As regards inconsistencies between approaches to Level 1 texts and Level 2 implementing measures, the CRR includes comprehensive risk retention provisions whereas the other pieces of legislation discussed above contain only outline provisions which require implementation through Level 2 measures.

3.6. Finally, the language of AIFMD Level 2 is inconsistent with the language of the AIFMD because it applies the restriction to a "securitisation" whereas—as noted above—the AIFMD refers to "securities or other financial instruments". One might infer that this is to increase consistency with the CRR but—if that is the case—it would be better for the Level 1 texts themselves (*i.e.*, the AIFMD and the CRR) to be consistent.

4. NETTING-RELATED TERMS UNDER THE RRD AND THE EXISTING *ACQUIS*

4.1. The FMLC considers that netting-related terms are used inconsistently in the proposed RRD. Such inconsistency is unfortunate in view of the further inconsistency and lack of clarity surrounding similar terms in the existing *acquis*. In February 2013, the FMLC published a paper discussing legal uncertainties arising from the RRD (the

[12] The word "originators" is in brackets following the phrase "firms that repackage loans into tradable securities or other financial instruments" (Article 135(2) of Solvency II and Article 50a of the UCITS Directive).

[13] The AIFMD makes reference to the equivalent definition in CRD II. Given that CRD II will soon cease to apply, this is rather unfortunate. However, to the extent that the definitions in CRD II and CRR are similar, this does provide for a certain level of coherence between the AIFMD and the CRR.

"**RRD Paper**"), a copy of which paper was sent to the Commission and to certain members of the European Parliament (including the Chairwoman of the ECON Committee, Sharon Bowles, and the *rapporteur* of the ECON Committee, Gunnar Hökmark).[14]

4.2. The key observations of the FMLC regarding netting-related terms in the RRD—which are set out in fuller detail in its RRD Paper—are as follows:[15]

(i) The RRD does not define "netting". Terms such as "netting agreement", "netting arrangement" and "close-out netting agreement" are used variously throughout the proposed text and it is not always easy to discern any justification for the inconsistency. Of these terms, only "netting arrangement" is the subject of further elaboration or description.[16] A number of examples of inconsistent or incoherent usage of netting-related terms in the RRD are set out in the RRD Paper.[17]

(ii) In particular, in the FMLC's view, the use of netting-related terms in the RRD without further clarification misses the opportunity to resolve a lack of clarity regarding the meaning of "netting agreement" in Directive 2001/24/EC on the reorganisation and winding-up of credit institutions (the "**CIWUD**") and the meaning of "close-out netting provisions" in Directive 2002/47/EC on financial collateral arrangements (the "**FCAD**").[18]

4.3. In the FMLC's view, such inconsistency and incoherence could be ameliorated by clarifying the meaning of netting-related terms—as they appear in the CIWUD and the FCAD—in the RRD. Consideration might then also be given to using the established terms "netting agreements" and "close-out netting provisions" in the RRD, to improve consistency with the existing *acquis*.

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14 A copy of the RRD paper—as well as other FMLC papers—is available online at http://www.fmlc.org/Pages/papers.aspx.

15 At pages 16 to 23 of the RRD Paper.

16 Article 68(2)(d) of the RRD.

17 At pages 17 to 19 of the RRD Paper.

18 *Ibid.*, at pages 19 to 22. See also the "Report on Protection for Bilateral Insolvency Set-Off and Netting Agreements under EC Law" (2004), published by the European Financial Markets Lawyers Group established by the European Central Bank, which identified similar uncertainties regarding the use of the word "*compensation*" in French legislative texts.

5. THE MEANING OF "ACTING IN CONCERT" IN THE ACQUISITIONS DIRECTIVE

5.1. The FMLC considers that there is inconsistency between the concept of persons "acting in concert", as it appears in the Acquisitions Directive and in Directive 2004/25/EC (the "**Takeover Directive**"). Furthermore, the FMLC considers that this incoherence may have led to inconsistent implementation of the Acquisitions Directive by individual Member States.

5.2. The Acquisitions Directive does not define the concept of persons "acting in concert". Broadly, it requires that specific provisions of Directive 2004/109/EC (the "**Transparency Directive**") regarding the aggregation of voting rights must be "taken into account" in the context of the provisions of the Acquisitions Directive where the concept of persons "acting in concert" appears.[19] The Transparency Directive does not use the phrase "acting in concert" but *inter alia* provides for a person's voting rights to be aggregated with those of a third party with whom that person has concluded an agreement requiring them both "to adopt, by a concerted exercise of the voting rights they hold, a lasting common policy towards the management" of the relevant entity.[20] It is not clear how those provisions are to be construed in the context of persons "acting in concert".[21]

5.3. A broad, non-binding definition contained in guidance published by the former three "Level-3 Committees" (the "**3L3 Guidelines**") states that persons are "acting in concert" when each person decides to exercise "rights linked to the shares he acquires in accordance with an explicit or implicit agreement... between them".[22] Taken

19 See Articles 1(2)(a), 2(2)(a), 3(2), 4(2) and 5(2) of the Acquisitions Directive, which cross-refer to Articles 9, 10 and 12(4) and (5) of the Transparency Directive. No further guidance is given as to what is required by the phrase "taken into account".

20 Article 10(1)(a) of the Transparency Directive. Article 10(1) also covers other circumstances where voting rights may be attributed to a person.

21 The FMLC considers that the areas of legal uncertainty arising from this lack of clarity are beyond the scope of this paper, but expects to write to the Commission (and other relevant institutions) in this regard in the future.

22 The Committee of European Banking Supervisors (CEBS), The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR): joint guidelines for the prudential assessment of acquisitions and increases in holdings in the financial sector as required by Directive 2007/44/EC (published in 2008), at Pt 1, Appendix I.. Cf. the Commission's report on the application of the Acquisitions Directive, published on 11 February 2013 (COM(2013) 64 final), which describes the 3L3 Guidelines definition as "very broad", at page 5.

literally, this definition could result in the holdings of persons being aggregated for the purposes of the Acquisitions Directive where they have, at any time, entered into any agreement to exercise their rights, even where there is no ongoing agreement regarding the management of the relevant entity. This may be inconsistent with the provisions of the Transparency Directive referred to above.

5.4. The concept of "persons acting in concert" is, however, defined in the Takeover Directive.[23] That definition clearly contemplates a takeover; however, it is conceptually inconsistent with the provisions of the Transparency Directive referred to by the Acquisitions Directive, which refer to an agreement to adopt a "lasting common policy towards the management" of the relevant entity. There is also no obvious reason why the definition in the 3L3 Guidelines (which refer to an "explicit or implicit agreement") should be inconsistent with that in the Takeover Directive (which refers to an agreement "either express or tacit, either oral or written").

5.5. In a report published in February 2013, the Commission observed that "the interpretation of this notion [of persons acting in concert] can be divergent to a limited extent" and also that "differences between the definitions" used in the relevant Directives "raise some concerns in the private sector".[24] The FMLC is concerned that the relevant provisions of the Acquisitions Directive may be implemented inconsistently by individual Member States and believes that further definition and clarification regarding the concept of "acting in concert" would be beneficial in addressing these concerns.[25] Accordingly, the FMLC welcomes the Commission's proposal to consider this issue as part of its review of the Takeover Directive and the Acquisitions Directive.

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[23] Article 2(1)(d) of the Takeover Directive.

[24] COM(2013) 64 final.

[25] In the UK, the Acquisitions Directive has been implemented as Part XII (*Control over authorised persons*) of the Financial Services and Markets Act 2000 ("**FSMA**"). The implementation of those provisions in the UK (and related guidance published by the Financial Services Authority) was the subject of some debate (SUP 11 Annex 6G, as introduced by the Change of Control (Aggregation of Holdings) Instrument 2011 (FSA 2011/2). This is unfortunate given the fact that failure to give notice and to complete the necessary approval procedure in advance of a relevant acquisition of control is a criminal offence under section 191F of the FSMA.

6. RULES FOR DETERMINING THE LOCATION OF ASSETS IN THE INSOLVENCY REGULATION

6.1. The FMLC believes that the rules for determining the location of contractual claims for the purposes of Article 5 (*Third parties' rights in rem*) of the Insolvency Regulation are not consistent with other conflict of law rules in the existing *acquis*.[26] In this regard, the FMLC recently circulated an as-yet-unpublished paper discussing the treatment of rights *in rem* under Article 5 to various members of DG Justice.[27]

6.2. Broadly, the FMLC considers that there are key differences between the centre of main interests ("**COMI**") test, as determined by Article 3(1) in the Insolvency Regulation, and the rules which determine the governing law or jurisdiction under the primary Regulations on conflict of laws enacted by the EU. Under the Insolvency Regulation, once insolvency proceedings have been initiated, questions regarding the nature of a proprietary interest in a claim will be governed by the law of the place where the obligor has its COMI. Under Regulation 593/2008 ("**Rome I**"), prior to the onset of insolvency, questions regarding the proprietary effects of the creation, assignment (including transfers by way of security or other security rights) or subrogation of claims will be allocated to the law of the claim in which the relevant security or similar proprietary interest has been created. That law will be the applicable law of the instrument giving rise to the claim.[28]

6.3. It is further noted that the "habitual residence" test under Rome I—for determining the governing law of a contract (in the absence of party choice) and hence the contractual law of a claim—does not precisely track the COMI test under the Insolvency Regulation.[29] For corporate bodies, the place of "habitual residence" is the centre of main administration (not the COMI) and, in the case of contracts made by branches, agencies or other establishments, the place of the relevant branch *etc.* This may be considered unfortunate; however, it is not of as much concern to the FMLC as the way in which choice of law rules—under the Insolvency Regulation and Rome I,

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26 The Insolvency Regulation is proposed to be amended by the Amendment Regulation. However, references to Articles in this Section 6 are to the Insolvency Regulation as currently in force, unless otherwise stated.

27 Recipients of that paper included Ms Niovi Ringou, Acting Head of Unit 1: Civil Justice Policy. The FMLC hopes that the content of that paper might be considered in the light of the proposed Amendment Regulation.

28 Article 14 of Rome I. Conversely, the relationship between the assignor and assignee of a claim against another person (the debtor) shall be governed by the law that applies to the contract between the assignor and the assignee.

29 *Ibid.*, Article 19.

respectively—potentially allocate questions regarding security rights to different legal systems depending on whether the corporate entity is subject to an insolvency proceeding or not.

7. LIABILITY OF CREDIT RATING AGENCIES UNDER CRA III

7.1. The FMLC considers that the liability regime for credit rating agencies ("**CRAs**") under CRA III is inconsistent with existing EU and national liability regimes. Furthermore, in the absence of further definition or guidance, CRA III is likely to be implemented inconsistently by individual Member States.

7.2. The final text of CRA III effectively introduces—under Article 35a—an EU-wide civil liability regime for negligence of CRAs. It does so by imposing a new cause of action on Member States' legal systems in a manner which is not consistent with existing EU liability regimes. Furthermore, it introduces concepts (such as "gross negligence") and principles that may not be in line with established national civil liability laws or rules of procedure and which may be implemented inconsistently by individual Member States.[30]

7.3. First, Article 35a is qualitatively different to the general position under equivalent EU liability regimes which require that obligations are enforced in accordance with Member States' civil liability regimes. The introduction of an EU-wide regime will thus likely lead to litigation regarding the nature and enforceability of rights conferred by Article 35a. Furthermore, the lack of convergence in Member States' legal systems is problematic in two senses: first, legal uncertainty will persist while each Member State decides on its interpretation of the various aspects of the regime; and secondly—in the absence of any provision in CRA III to address matters such as limitation periods, rules of evidence and quantification of loss—both procedure and substantive law and regulation are capable of producing materially different outcomes in otherwise identical circumstances.

7.4. Secondly, Article 35a(3) provides that a CRA may have an action brought against it if it has demonstrated "gross negligence". There is, however, uncertainty as to the meaning of "gross negligence". Article 35a(4) provides that that term and other terms

[30] In November 2012, the FMLC sent a letter to the Chairwoman of the ECON Committee, Sharon Bowles, reiterating certain concerns regarding CRA III. Since the date of that letter, the final text of CRA III has been approved following a European Parliament vote and adopted by the Council. The final text of CRA III was published in the Official Journal on 31 May 2013 and will enter into force on 20 June 2013. The final text of CRA III addressed, to some extent, the concerns raised by the FMLC in relation to the Commission's original proposal.

which are referred to in [Article 35a] but are not defined, shall be interpreted and applied in accordance with the applicable national law as determined by the relevant rules of private international law.

A failure to define clearly the standard of negligence required under this Article is likely to lead to uncertainty that will persist until the term has been interpreted by the courts. The term may also be interpreted differently across Member States, which could lead to a divergence in regulatory standards across the EU.

8. LIABILITY OF DEPOSITARIES UNDER UCITS V

8.1. The FMLC considers that the civil liability standards for depositaries under UCITS V (as currently proposed) are inconsistent with the liability standards set out in the AIFMD. The FMLC also considers that certain provisions under UCITS V are inconsistent with civil procedures in some national regimes and give rise to internal incoherence within the proposed text itself.

8.2. Under Article 24(1) of UCITS V, a depositary may be liable for loss caused to the relevant UCITS or to a unit-holder of the UCITS.[31] A depositary is prohibited from contractually limiting its liability under Article 24(1) and any agreement which purports to limit such liability shall be "void".[32] By contrast, Article 21(13) of AIFMD allows a depositary to limit its liability by "written contract", subject to certain conditions.[33] Prohibiting depositaries from limiting their liability for the loss of financial instruments also runs contrary to the general tenor of Member States' existing legal regimes. The FMLC notes that, in the case of agreements between commercial parties, the right to limit liability is generally accepted in many jurisdictions (including under English law).

8.3. Furthermore, UCITS V provides that a depositary shall be released from its liability for loss of financial instruments only where that depositary can prove that it could not

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31 Under Article 24(1), EU Members States must ensure that the depositary shall be liable to the UCITS and to the unit-holders of the UCITS for the loss caused by the depositary or a third party to whom the custody of financial instruments has been delegated. The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

32 This is set out under Article 24(3) and 24(4) of UCITS V.

33 See Article 102 of AIFMD Level 2, which sets out certain "objective reasons" a depositary must establish to limit its liability for the purposes of Article 21(13).

have avoided the loss despite taking all reasonable efforts to the contrary, thereby reversing the evidential burden of proof. This approach is inconsistent with the civil procedural rules observed in many Member States. There is, therefore, a risk that this reversed burden of proof under UCITS V could invite litigation which may lead to an inconsistent application of regulatory standards across the EU.[34]

8.4. The FMLC considers that Recital 23 of UCITS V and Article 24(5) of the Presidency Compromise Text give rise to internal incoherence.[35] Recital 23 states "redress against the depositary should not depend on the legal form that a UCITS fund takes". By contrast, Article 24(5) provides that liability may be invoked "depending on the legal nature of the relationship between the depositary, the management company and the unit holders". The FMLC has been given to understand that Article 24(5) reflects market practice where standard contractual arrangements are established between the manager of the UCITS and the depositary. This incoherence may result in inconsistent implementation by individual Member States.

9. ALGORITHMIC AND HIGH FREQUENCY TRADING

9.1. The FMLC has observed inconsistency between the proposed EP MAR and MiFID II, as those proposals would pertain to algorithmic and high frequency trading. Specifically, Article 10a of EP MAR would appear to overlap with Article 17 of MiFID II.

9.2. Article 17(2) of MiFID II obliges an investment firm to provide information on its algorithmic trading strategy to the relevant competent authority. Article 10a(3) of EP MAR covers the same subject matter—that Article sets out requirements as regards the updating of the type of information referred to in Article 17(2) of MiFID II.

9.3. If the proposed legislation is implemented, the result of the overlap described above is likely to be confusion and uncertainty for financial markets participants who may find it difficult to navigate the rules to which they are subject. As a general recommendation, the FMLC believes that coherence is increased where regulatory rules concerned with a particularly subject matter are consolidated as far as possible in the same legislation. Where that is not possible or desirable, the FMLC acknowledges

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[34] The FMLC notes that, in earlier versions of CRA III, the burden of proof was reversed; in the final text of CRA, the burden of proof falls on the claimant. This development was broadly consistent with the recommendations of the FMLC letter of November 2012 regarding CRA III—see fn 30 above.

[35] Presidency Text of 11 December 2012 (2012/0168(COD)).

that the inclusion of cross-references between the provisions of different pieces of legislation—*e.g.,* the reference in Article 10a of EP MAR to Article 17 of MiFID II—can help increase coherence.

9.4. Furthermore, Article 10a of EP MAR appears inconsistent with Article 17(3) of MiFID II. Article 17(3) requires quoting behaviour by a firm engaging in algorithmic trading—such as posting "firm quotes at competitive prices with the result of providing liquidity on a regular and ongoing basis—that could conflict with Article 10a(1) of EP MAR, which obliges trading venues to have in place rules to prevent "abusive order entry". A similar point can be made in relation to Article 10a of EP MAR and Article 51(1a) of MiFID II, as amended by the European Parliament.

9.5. The effect of this inconsistency—should the proposed legislation come into force—may be to render firms liable under market abuse legislation for actions taken pursuant to other European regulatory rules. It is important that conflicting requirements are not placed on market participants, as it could be difficult or impossible for them to comply with the applicable rules in such a situation. This point appears all the more significant where the consequences of breach may include the imposition of significant administrative measures and sanctions, as is provided for under market abuse legislation.

10. CLIENT PROTECTIONS UNDER MIFID

10.1. The FMLC considers that the resolution objectives and principles in the RRD are inconsistent with the "organisational requirements" outlined in MiFID. The FMLC has previously commented on this topic in its RRD Paper.[36] Such inconsistency could create confusion in the interpretation of key concepts in this area.

10.2. The FMLC considers that, where definitions of core concepts across legislation cannot be harmonised, cross-references can aid interpretation by providing the necessary consistency. The absence of relevant cross-references may result in inconsistent interpretations. In this regard, the FMLC takes the view that Article 26(2)(f) of the RRD—which provides that resolution authorisation must have regard to the need "to protect client funds and client assets"—should expressly refer to

[36] See Section 4 and fn 14 above.

certain relevant provisions within Article 13 of MiFID[37] to maintain legislative consistency.[38]

10.3. Furthermore, Article 29 of the RRD specifies the general principles that resolution authorities must take into account when applying resolution tools and exercising resolution powers. There would be merit in introducing a new principle into Article 29 of the RRD in contemplation of Article 13(7) of MiFID, pursuant to which a client's instruments should not be used on the institution's account except with the client's express consent.

10.4. The FMLC considers that instances of inconsistency or incoherence have arisen as a result of varying interpretations of Article 13(8) of MiFID in some Member States. In February 2013, the FMLC commented on this issue in a paper published in response to an FSA consultation paper on the client assets regime.[39]

10.5. Article 13(8) of MiFID provides that an investment firm must, among other things, make adequate arrangements to safeguard clients' rights when holding client assets, "except in the case of credit institutions". Some Member States have interpreted this Article as providing credit institutions with an absolute carve-out from the provisions concerning the protection of clients' funds, notwithstanding the wording in Article 18(1) of Directive (2006/73/EC), which implements MiFID and makes it clear that the carve-out only applies to deposits within the meaning of the Banking Consolidation Directive (2006/48/EC). The inconsistency between those Directives could have the consequence of making the position relating to the branches of such banks less clear in the context of a client monies regime. By way of example, where a bank incorporated in another Member State holds segregated client positions at a central counterparty, those positions will benefit from the default protections in Article 48 of Regulation (EU) 648/2012 ("**EMIR**") but it may not be clear that clients will benefit from the protections of the host state client monies rules implementing MiFID.

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37 Article 13 of MiFID sets out specific organisational requirements with which investment firms must comply.

38 Article 26(2)(f) of the RRD might be amended to provide that a resolution authority must have regard to the following objective: to safeguard clients' ownership rights in accordance with Articles 13(7) and (8) of MiFID and Article 16 of Directive 2006/73/EC.

39 The paper is entitled "Response to the FSA Consultation Paper entitled "Client assets regime: EMIR, multiple pools and the wider review" (CP12/22) Report" and can be accessed on the FMLC's website—see fn 14 above.

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APPENDIX 2 – PAPER ON INDIRECT CLEARING

FINANCIAL MARKETS LAW COMMITTEE

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

DECEMBER 2015

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FINANCIAL MARKETS LAW COMMITTEE

This paper has been drafted by the FMLC Secretariat[1]
following discussion at a meeting of the FMLC Infrastructure Scoping Forum.[2]

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[1] Joanna Perkins (FMLC Chief Executive) and Sherine El-Sayed (FMLC Project Secretary). The FMLC Secretariat would like to thank Mark Bines and Joe Kohler of Deutsche Bank and members of the Financial Markets Law Committee ("**FMLC**") for their comments.

This paper draws on expertise from the FMLC's earlier work on indirect clearing entitled "Issues of Legal Uncertainty Arising in the Context of Indirect Clearing of Exchange Traded Derivatives under MiFIR", 16 October 2015, hereafter referred to as the "**October 2015 Paper**". Contributions to that paper were made by the following individuals: Avril Forbes (then FMLC Legal Assistant, now of Clifford Chance LLP), Joe Kohler and Mark Bines of Deutsche Bank as well as Sean Kerr of Clifford Chance LLP.

[2] Members of the Forum who were in attendance include: Farid Anvari (Baker & McKenzie LLP), Adam Eades (BATS Chi-X Europe), Anouk Gauthier (London Metal Exchange Group), Will Ingram (CME Group) and Paul Vine (Norton Rose Fulbright LLP).

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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

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

1.2. On 5 November 2015, the European Securities and Markets Authority ("**ESMA**") published draft regulatory technical standards ("**RTS**") under cover of a consultation paper (No. 2015/1628, the "**Consultation Paper**") concerning the implementation of indirect clearing arrangements for: (i) over-the-counter ("**OTC**") derivatives under Regulation (EU) No 648/2012 ("**EMIR**"); and (ii) exchange traded derivatives ("**ETDs**") under Regulation (EU) 600/2014 ("**MiFIR**"). The aims of the Consultation Paper and the draft RTS are to ensure appropriate protections for investors and thereby promote the objectives of EMIR and MiFIR in increasing the resiliency of the markets to which the RTS apply and reducing overall systemic risk. The FMLC welcomes the progress which has been made in achieving these aims. It considers, however, that the provisions of the draft RTS may give rise to one or two issues of legal uncertainty which could helpfully be clarified. These issues are examined in this paper.

1.3. In a paper published in October 2015 (the "**October 2015 Paper**"),[3] the FMLC responded an earlier consultation by ESMA on, among other things, the appropriate arrangements for the indirect clearing of ETDs.[4] That consultation sought comments on draft RTS under MiFIR (the "**First Draft RTS(M)**").[5] This paper follows on from the October 2015 Paper and reviews a re-draft of the consultative regulatory technical standards for indirect clearing set out in Annex IV to the Consultation Paper (the "**Second Draft RTS(M)**").

1.4. Indirect clearing requirements were previously developed by ESMA for OTC derivatives in the context of EMIR and these were subsequently brought into force

[3] The October Paper (*ibid.*) responds to ESMA Consultation 2014/1570 and can be accessed at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_indirect_clearing.pdf.

[4] ESMA Consultation 2014/1570.

[5] The First draft RTS(M), annexed to ESMA Consultation 2014/1570, was referred to in the October 2015 Paper as "**Draft RTS 38**", for the sake of distinguishing a number of RTS on different aspects of the Markets in Financial Instruments Regulation ("**MiFIR**") which were being consulted on by ESMA at the same time.

under Delegated Regulation (EU) No 149/2013. The Consultation Paper has been published to: (a) initiate a review of the EMIR requirements to ensure they continue to fulfil their objective; and (b) harmonise those requirements as far as possible with the MiFIR requirements for indirect clearing which are being developed. In this regard, the Consultation Paper considers specific amendments to Delegated Regulation (EU) No 149/2013. The Consultation Paper is also designed to: (c) invite comments on a new version of the draft RTS for MiFIR that takes into account the feedback from the earlier consultation on indirect clearing and the "consistency requirement" of the MiFIR mandate.[6]

1.5. The draft RTS amending Commission Delegated Regulation (EU) No 149/2013 with regard to regulatory technical standards on indirect clearing (the "**Draft RTS(E)**"), included in the Consultation Paper, incorporates a similar approach to that in the Second Draft RTS(M) in respect of requirements for clearing members and clients to facilitate leapfrog payments. To the extent that the language is the same, the analysis provided below in respect of the Second Draft RTS(M) also applies to the changes introduced by the Draft RTS(E).

Executive Summary

1.6. This paper examines issues of uncertainty arising from the Second Draft RTS(M) and observes that many of the concerns raised in the October 2015 Paper, in relation to the First Draft RTS(M), still apply. In particular, analysis is provided in respect of Article 4(7) in the Second Draft RTS(M), which requires a clearing member to establish procedures to manage the default of a client which include "steps… to initiate the payment of the liquidation proceeds to each of the indirect clients". The effect of this provision is to require a clearing member to make payments—which would be otherwise be paid to a direct client—to an indirect client ("leapfrog payments") in the event of a default by the direct client. ESMA has amended this provision (which also appeared in the First Draft RTS(M)) but the changes do not address potential conflicts of law in respect of existing national insolvency regimes, which are particularly acute with respect to third country legal systems.

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6 Article 30(1) of MiFIR sets out the "consistency requirement":

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

1.7. In drawing up the First Draft RTS(M), ESMA was aware that conflicts of law might arise not only in respect of third country insolvency regimes but also, potentially, in respect of the national insolvency laws of EU Member States. ESMA sought to pre-empt the latter possibility by, among other things, inserting a recital which stipulated that the provisions of the RTS would override any "conflicting laws, regulations and administrative provisions of Member States". The recital has been deleted and does not appear in the Second Draft RTS(M). This paper observes that the removal of the recital is not sufficient, however, to deal with any underlying issues of uncertainty that might arise.

1.8. ESMA has also made changes to the First Draft RTS(M) to deal with conflicts of law more generally, including those which might arise in respect of third country insolvency regimes. These are introduced under Articles 4(7), 5(7) and 5(8) of the Second Draft RTS(M) and impose new requirements on clearing members and direct clients to incorporate contractual obligations and establish specific arrangements in relation to default management. While these provisions go some way to ameliorating conflicts of law, they do not provide a complete solution. Further detail is provided in the sections below.

2. LEAPFROG PAYMENTS AND INSOLVENCY LAW CONFLICTS

2.1. The Consultation Paper acknowledges that the greater part of the feedback on the First Draft RTS(M) focused on the issue of the potential conflict between the requirement for leapfrog payments and the insolvency laws of third country jurisdictions.[7] The FMLC takes the view that the Second Draft RTS(M), which preserves the requirement for leapfrog payments—albeit only in respect of indirect

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[7] See para 24, p.9 and section 3.2., p.11 to 13 of the Consultation Paper. With regard to conflicts with third country legal systems, the Consultation Paper expressly stipulates that "the EU legal framework cannot override the third country insolvency regime" (para 36, p.11). Furthermore, Recital 10 of the Second Draft RTS(M) provides that:

> [i]n some circumstances the direct return of the liquidation proceeds to the indirect client could not be conducted. The failure of a client providing indirect clearing services and established in a third country where the insolvency regime would not allow the direct return of the liquidation proceeds would require the clients, in collaboration with the clearing member and the indirect clients, to put in place contractual arrangements to protect to the extent possible the positions and assets of the indirect client from insolvency challenge, ensuring that if direct return cannot be achieved, any liquidation proceeds returned to a defaulted client for the account of indirect clients does not form part of that defaulted client's insolvency estate.

This recital does not sufficiently deal, however, with conflicts of laws issues with respect to third country jurisdictions.

clients who have chosen a gross omnibus indirect account structure[8]—has not fully addressed these concerns.

2.2. The FMLC also takes the view that uncertainty may possibly arise where the requirements of the Second Draft RTS(M) conflict with the national insolvency laws of EU Member States.[9] Recital 64 of EMIR was an attempt to deal with conflict of laws issues for OTC derivatives clearing by providing that the requirements of EMIR on the segregation and portability of clients' assets and positions should prevail over any conflicting provisions of Member States' laws. The First Draft RTS(M) emulated this approach by incorporating a recital (Recital 5) with similar wording to that of Recital 64 in EMIR. The FMLC previously noted that it was unclear whether a recital in a delegated regulation could override Member States' insolvency law. The recital does not appear in the Second Draft RTS(M). Any potential conflicts of law issue is left apparently unresolved.[10]

2.3. ESMA's response to the conflict of laws issues which were raised by stakeholders in their comments on the First Draft RTS(M)—set out in three new provisions of the Second Draft RTS(M)—is discussed in greater detail below.

2.4. The Second Draft RTS(M) incorporates new provisions which are intended to deal with a potential conflict between mechanisms designed to safeguard the position of indirect clients vis-à-vis a defaulting client and any rules of local insolvency law—whether of an EU Member State or of a third country—which might prohibit a transfer of liquidation payments away from the defaulting client. These provisions require parties to enter into contractual obligations that would: (i) commit the clearing member to trigger the procedures for the transfer of assets and positions held by the defaulting client for the account of its indirect clients to a substitute client (Article 4(7)); and (ii) include terms which provide that the client will facilitate the

8 The FMLC welcomes this clarification. A gross omnibus indirect account structure is the segregation option set out in Article 4(2)(b) of the Second Draft RTS(M), which may be contrasted with either an (ordinary) omnibus account or an individually segregated account. Recital 6 provides more information on the merits of the gross omnibus indirect account structure.

9 This issue was raised in the October 2015 Paper. For more information on specific insolvency rules with which the provisions of the Second Draft RTS(M) would conflict, see section 3 of the October 2015 Paper.

10 Article 30 of MiFIR provides a mandate for ESMA to establish the indirect clearing requirements set out in the Second Draft RTS(M). MiFIR itself, however, does not contain a recital similar to Recital 64 of the Regulation over-the-counter ("**OTC**") derivatives, central counterparties and trade repositories ("**EMIR**") or any equivalent provision. Uncertainty arises because, although MiFIR itself has direct and, therefore, overriding effect where it conflicts directly with national laws, it is questionable whether the Article 30 mandate can, without any additional provision, confer on the RTS the kind of implied effect which will disapply any provision of national insolvency law that might render the requirements of the RTS operationally ineffective or more costly to implement.

prompt return to the indirect client of the proceeds from the liquidation of the positions and assets held by the clearing member for the account of the indirect client (Article 5(7)). An obligation requiring the client to have necessary arrangements in place to ensure that any proceeds do not form part of its insolvency estate is also included (Article 5(8)). The full set of these provisions is set out in Annex 1 to this paper.

2.5. Article 4(7) in the Second Draft RTS(M) now establishes a requirement that the parties commit contractually at the outset to transfer liquidation proceeds to a substitute client at the request of indirect clients in the event of a default by a direct client. This requirement—contemplated by Article 30(1) of MiFIR[11]—is in addition to the leapfrog payments requirement, which will apply in the event that no request for such a transfer is made by the indirect client.

2.6. The FMLC considers that the issues of uncertainty raised in the October 2015 Paper are equally salient in respect of this new provision. Third country insolvency laws which invalidate a transfer of property away from an insolvent entity—in this case the defaulting client—may, as the FMLC noted, conflict with the requirement for leapfrog payments. Any laws of this kind may, however, also provide a platform from which to challenge a contractual commitment which accords with the new requirement.[12]

2.7. Some uncertainty may also exist vis-à-vis the national insolvency laws of EU Member States. Although MiFIR itself must be given effect to where it conflicts with Member States' laws, there may be some doubt whether the Article 30 mandate can, without additional provision, furnish delegated technical standards with the

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[11] Article 30(1) of MiFIR furnishes ESMA with a mandate to produce RTS equivalent in effect to Article 48 of EMIR. Under Article 48(5) of EMIR, a central counterparty, must

> contractually commit itself to trigger the procedures for the transfer of assets and positions held by the defaulting clearing member for the account of its clients…

[12] For example, the "anti-deprivation" principle—replicated in several of the legal systems of the Commonwealth—can operate to invalidate any contractual term which stipulates that property owned by a debtor will be removed from its estate in the event of its insolvency. The principle, which applies equally to personal and corporate insolvency, has been summarised in English case law as follows:

> [A] simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of bankruptcy should go over to someone else and be taken away from his creditors is void as being a violation of the policy of bankruptcy laws (James LJ, Ex parte Jay: In Re Harrison (1880) 14 Ch D 19.25).

kind of implied effect which will override national insolvency laws and guarantee the legal enforceability of the required contractual commitments.

2.8. Article 5(8) is intended to support the requirement for leapfrog payments by requiring that the direct client must have in place the necessary arrangements to ensure that liquidation proceeds do not from part of the client's insolvent estate. Unlike other requirements, this provision is not specifically contemplated by the mandate in Article 30(1) text of MiFIR.

2.9. Article 5(8) requires the client to achieve a particular ring-fencing outcome. Absent a change to insolvency law for EU Member States, however, it remains unclear how a client can and should ensure that assets and positions are ring-fenced from its insolvency estate. A simple contractual commitment that liquidation proceeds will be transferred away from a defaulting client will not, as discussed above, safely "ensure" that those proceeds do not from part of its insolvent estate. Structures which could achieve this outcome, on the other hand, would need to be established at the outset of the parties' relationship and be highly robust, if not bankruptcy remote. They might include a trust mechanism in favour of the indirect client or a security over the relevant assets with the clearing member. To the extent that these structures did not conflict with existing principles of insolvency law of the kind discussed above, they would be costly to implement and would require bespoke solutions to be created for each client, depending on its jurisdiction. This could, therefore, negate the advantages of indirect clearing (i.e. the requirement could ultimately create a higher barrier to entry than a direct clearing relationship). It is unlikely that such an outcome is intended by ESMA.

3. LONGER INDIRECT CLEARING CHAINS

3.1. Article 5(8) is to be applied as contemplated by Article 5(1). That is, an indirect client that itself provides indirect clearing services to an end-user (the "**end-user**") will be subject to the requirements set out paragraphs (2) to (8) of Article 5 as if it were a client. This expressly establishes technical standards applicable to longer indirect clearing chains. There are, however, a number of interpretive difficulties in applying the requirements of the Second Draft RTS(M) to these longer chains.

3.2. Longer indirect clearing chains are not contemplated by MiFIR (or, in the case of the Draft RTS(E), by either EMIR or by Delegated Regulation (EU) No. 149/2013). The principal means by which technical standards for these chains have been introduced, therefore, is by the introduction of a new definition of "indirect client" in Article 1(1), which refers not only to undertakings with a direct contractual relationship with a client of a clearing member but also to undertakings with an *indirect* contractual relation with a client. (In the case of the Draft RTS(E), this definition replaces the existing, more limited definition in Delegated Regulation (EU) No. 149/2013).

3.3. This new definition has the effect that, unless otherwise intended, all the provisions of the Second Draft RTS(M)—and (E)—apply in respect of end-users, i.e. indirect clients of indirect clients. This leads to interpretive difficulties in many instances where the provision in question assumes a direct relationship between the client and the indirect client or between the clearing member and the client. Instances of this problem are several, including: (i) the provisions of Article 4 which impose obligations on clearing members vis-à-vis indirect clients—where it is difficult to ascertain the intention of the article in relation to end-users, particularly where both the indirect client and the client may be in default; and (ii) the provisions of Article 5, which—as discussed above—impose obligations on indirect clients providing clearing services to end-users as if they were clients but nevertheless appear to assume a contractual relationship between the "client" and the clearing member (see, e.g., Article 5(4)).

3.4. It would be helpful if further clarification could be provided in this regard. The FMLC notes that the more intermediaries that are subject to the provisions in Articles 4 and 5 of the Second Draft RTS(M), the more the legal uncertainties set out above will be exacerbated.

4. PROPOSED SOLUTIONS

4.1. The proposed solutions highlighted in the October 2015 Paper would assist in providing further clarity in respect of the Second Draft RTS(M). For ease of reference, an excerpt of the proposed solutions set out in the October 2015 Paper is incorporated at Annex 2 of this paper. The FMLC would also recommend further

clarification in respect of applicability of the default management procedures to longer indirect clearing chains.

5. CONCLUSION

5.1. This paper has identified issues of legal uncertainty in respect of Articles 4(7) and 5(8) of the Second Draft RTS(M). Uncertainty arises in respect of the requirements set out in Article 4(7), which is supported by Article 5(8), as to both contractual commitments to transfer liquidation proceeds away from defaulting direct clients and leapfrog payments. These requirements may conflict with national insolvency laws, particularly those of third countries. This paper has also drawn attention to interpretative difficulties that are likely to arise both for clearing members and indirect clients in respect of longer indirect clearing chains.

5.2. As noted in the FMLC's paper of October 2015, legal uncertainty in this area could have a negative impact on the wholesale financial markets. Indirect clearing arrangements are common for ETDs. Without a practical solution, parties to these transactions would not be able to rely on payments or transfers of liquidation proceeds being immune from challenge.

ANNEX 1

1. Article 1(1) of the Second Draft RTS(M) states

   "indirect client" means an undertaking with a direct or indirect contractual relationship with a client of a clearing member which enables that undertaking to clear its transactions with a CCP.

2. The obligations of the clearing member and direct client are set out in Article 4 and Article 5 of the Second Draft RTS(M). The provisions of Article 4 stipulate:

   1. A clearing member that offers to facilitate indirect clearing services shall do so on reasonable commercial terms. Without prejudice to the confidentiality of contractual arrangements with individual clients, the clearing member shall publicly disclose the general terms on which it is prepared to facilitate indirect clearing services. These terms shall include minimum operational requirements for clients and indirect clients that provide indirect clearing services.

   2. When facilitating indirect clearing arrangements, a clearing member shall implement at least any of the following segregation arrangements as indicated by the client:

      (a) keep separate records and accounts enabling each client to distinguish in accounts with the clearing member the assets and positions of the clients from those held for the accounts of its indirect clients;

      (b) keep separate records and accounts enabling each client to:

         (i) distinguish in accounts with the clearing member the assets and positions of the client from those held for the accounts of its indirect clients; and

         (ii) distinguish in records the positions and the collateral value, after applying any haircut as agreed between the counterparties, held for the account of each

indirect client within an omnibus indirect client account.

3. When a client manages the assets and positions of several indirect clients in a single account with the segregation option provided for in paragraph 2(b), the clearing member shall ensure that the CCP has all the necessary information to identify the positions and the collateral value held for the account of each indirect client in the account on a daily basis. This information shall be based on the information referred to in Article 5(2).

4. A clearing member that offers to facilitate indirect clearing services shall transfer to the CCP the collateral value, after applying any haircut as agreed between the counterparties, it received from its client for the account of each indirect client under segregation option in paragraph 2(b), which does not include any additional collateral received above the margin amount called by the clearing member.

5. A clearing member that offers to facilitate indirect clearing services shall open a segregated account at the CCP for the exclusive purpose of holding the assets and positions of the client's indirect clients.

6. A clearing member that offers to facilitate indirect clearing services shall disclose the information under Article 39(7) of Regulation (EU) No 648/2012 with reference to the segregation arrangements available to clients that provide indirect clearing services.

7. A clearing member shall establish robust procedures to manage the default of a client that provides direct clearing services.

   The clearing member shall, at least, contractually commit itself to trigger the procedures for the transfer of the assets and positions held by the defaulting client for the account of its indirect clients to another client designated by all those indirect clients, on their request and without the consent of the defaulting client. That

other client shall be obliged to accept those assets and positions only where it has previously entered into a contractual relationship with the indirect clients by which it has committed itself to do so.

The clearing member shall have procedures allowing the prompt liquidation of the assets and positions of indirect clients following the default of the client, in case the transfer to that other client has not taken place for any reason within a predefined transfer period specified in the indirect clearing arrangements. The procedures shall provide for the details of the communication from the clearing member to the indirect client s regarding the default of the client and the period of time during which the relevant indirect client portfolios will be liquidated. The assets held for the account of the indirect clients and distinguished in accordance with paragraph 2 shall be used exclusively to cover the positions held for their account.

When the assets and positions of one or more indirect clients are managed under the segregation option provided in paragraph 2(b), the procedures shall include the steps required to initiate the payment of the liquidation proceeds to each of the indirect clients.

After the completion of the default management process for the default of a client, and when the clearing member has not been able to identify the indirect clients or to complete the payment of the liquidation proceeds to each of the indirect clients, the clearing member shall readily return to the client for the account of the indirect clients any balance owed to the indirect clients by the clearing member.

8. A clearing member shall identify, monitor and manage any risks arising from facilitating indirect clearing arrangements, including the use of the information provided by clients under paragraph 4 of Article 5. The clearing member shall establish robust internal procedures to ensure this information cannot be used for commercial purposes.

3. Article 5 the Second Draft RTS(M) includes the following provisions:

    1. An indirect client that provides indirect clearing services shall be subject to the requirements of paragraphs 2 to 8 as if it was a client.

    2. A client that provides indirect clearing services shall keep separate records and accounts that enable it to distinguish between its own assets and positions and those held for the account of its indirect clients. It shall offer indirect clients a choice between the alternative account segregation options provided for in Article 4(2) and shall ensure that indirect clients are fully informed of the risks associated with each segregation option. Where an indirect client does not reply to a request of the client to disclose its choice of account segregation within a reasonable deadline fixed by the latter, the client shall be permitted to use the account segregation option provided for in Article 4(2)(a). The client should inform the indirect client accordingly, provide the indirect client with the relevant information about the risks associated with the account segregation, and explain that this does not preclude the indirect client from electing a different level of segregation at any time by communicating it in writing to the client.

    3. When a client manages the assets and positions of several indirect clients in a single account with the segregation option provided for in Article 4(2)(b), the client shall ensure that the clearing member has all the necessary information to identify the positions and the collateral value held for the account of each indirect client in the account on a daily basis. Any additional collateral received above the margin amount called by the clearing member shall be treated in accordance with the relevant terms of the indirect clearing arrangements.

    4. A client that provides indirect clearing services shall request the clearing member to open a segregated account at the CCP. The account shall be for the exclusive purpose of holding the assets and positions of its indirect clients.

5. A client that provides indirect clearing services shall disclose the details of the different levels of segregation and a description of the risk involved with the respective levels of segregation offered.

6. A client shall provide the indirect client with sufficient information to identify the CCP and the clearing member used to clear the indirect client's positions.

7. When the assets and positions of one or more indirect clients are managed under the segregation option provided for in Article 4(2)(b), the client that provides indirect clearing services shall include, in its contractual arrangement with indirect clients, terms to facilitate the prompt return to the indirect client of the proceeds from the liquidation of the positions and assets held by the clearing member for the account of the indirect client.

8. A client shall have the necessary arrangements in place to ensure that any liquidation proceeds received by the client for the account of one or more indirect clients does not form part of the client's insolvency estate.

9. A client shall provide the clearing member with sufficient information to identify, monitor and manage any risks arising from facilitating indirect clearing arrangements, including information on the number of entities involved in the indirect clearing arrangements and the jurisdictions of these entities. Prior to a default, clients should put arrangements in place to the effect that, in the event of default of the client, all information held by the client in respect of its indirect clients shall be made immediately available to the clearing member. In particular, in the event of default of the client, the client shall provide immediately the clearing member with sufficient information to identify the indirect clients in relation to the information under paragraph 2.

ANNEX 2

PROPOSED SOLUTIONS

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

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

2. Recognising that a leapfrog payment may not be feasible in all circumstances, such as where the identity of the indirect client is unknown, the FMLC suggests that it may be appropriate for exceptions to apply to the obligation to make a leapfrog payment. This also reflects the analogous position under EMIR. Article 48(7) of EMIR requires a CCP to make a leapfrog payment to a direct client in the event of a default by a clearing member, however, this obligation is not absolute—Article 48(7) expressly contemplates circumstances where such a payment would not be possible and permits payment to be made instead to the liquidator of the clearing member.[13]

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

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

Recital 5 of the First Draft RTS(M)

5. As outlined above in Section 4, it is unclear in Recital 5 whether third country firms are intended to be prohibited from providing indirect clearing services, where the requirements of the First Draft RTS(M) conflict with the relevant third country insolvency laws. The FMLC observes that, if an exception were made to the

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

requirement to make a leapfrog payment in such circumstances, third country firms would not be prevented from providing indirect clearing services and consequently Recital 5 would be unnecessary in this respect.

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