FINANCIAL MARKETS LAW COMMITTEE

4 August 2015

Jonathan Faull
Director General, DG Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels
Belgium

Dear Mr Faull

Draft Regulatory Technical Standards (the "Draft RTS") on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 ("EMIR")

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

On 10 June 2015, the European Supervisory Authorities published a second consultation on the Draft RTS. The Draft RTS were previously the subject of a first consultation which was published on 10 April 2014. Following the first consultation, the Draft RTS were revised and the second consultation focusses on a narrow sub-set of outstanding issues. The FMLC published a paper in response to the first consultation (the "**FMLC Paper**", attached) and would like to follow up in respect of certain issues raised in the FMLC Paper in the context of the second consultation.[1] As an overarching matter to inform the Draft RTS, the FMLC would also like to draw attention to its recent work on the co-ordination of the reform of international financial regulation (published 2 February 2015, the "**G20 Paper**").[2]

In the FMLC Paper, the FMLC, *inter alia*, drew attention to the issue of legal uncertainty as to whether title transfer collateral arrangements ("**TTCAs**") were compatible with Article 1 SEG (Segregation of Initial Margins), in terms of whether the requirements of Article 1 SEG for initial margin could be met using TTCAs. This issue was subsequently discussed at a meeting which I held on 9 September 2014 with representatives of the European Banking Authority (copied) who referred the FMLC to the European Commission on the grounds that the issue was one properly to be determined under primary European legislation, namely EMIR. Accordingly, I sent a letter on behalf of the FMLC, dated 22 December 2014, to Patrick Pearson at DG FISMA (the "**FMLC Letter**").[3] I attach a copy of that correspondence.

Article 1 SEG requires that collateral "collected as initial margin shall be segregated from *proprietary assets*..." (emphasis added) so as to "protect the initial margin from the default or insolvency of the collecting counterparty...". A TTCA involves the transfer of title to collateral from the collateral provider to the collateral taker. Accordingly, the

T +44 (0)20 7601 4286
contact@fmlc.org

8 Lothbury
London EC2R 7HH
www.fmlc.org

1 See the FMLC paper dated August 2014.

2 See the FMLC paper dated 2 February 2015.

3 See the FMLC letter to the European Commission dated 22 December 2014.

assets transferred as collateral pursuant to a TTCA would *legally* constitute the "proprietary assets" of the collateral taker.

If Article 1 SEG requires initial margin not to constitute the proprietary assets of the collecting counterparty, *prima facie*, it is incompatible with TTCAs. In the FMLC Paper, however, the FMLC distinguished between segregation in law and segregation in fact, observing that the latter could be achieved by operational segregation. For example, initial margin transferred to the collecting counterparty by way of a TTCA could be held on a segregated basis in an account with a third party custodian and, for the purposes of protecting the initial margin from the insolvency of the collecting counterparty, the collecting counterparty could charge back its rights to the account in favour of the collateral provider.[4]

The FMLC Paper noted that Article 1 SEG was unclear as to whether operational segregation was permissible and welcomed clarification on this point. At the meeting on 9 September 2014, representatives of the EBA indicated that TTCAs and the charge-back structure did not appear to be precluded by, or inconsistent with, the Draft RTS. The FMLC therefore sought confirmation of this view from the European Commission in the FMLC Letter but this did not receive a response. The second consultation was then published.

While Article 1 SEG has been amended following the first consultation, this point of legal uncertainty remains and the second consultation presents an opportune context in which to revisit it. Accordingly, in response to question 6 of the second consultation,[5] the FMLC respectfully requests that it be clarified whether TTCAs are within the scope of Article 1 SEG, in cases where operational segregation—and sufficient protection for the initial margin—is achieved by appropriate legal and structural mechanisms.

The second consultation provides that the Draft RTS are based on internationally agreed standards as the "natural starting point" to ensure "international consistency" and "a global level playing field".[6] The FMLC commends this approach, subject to one or two cautionary remarks informed by the G20 Paper.

The G20 Paper considers the international implementation of the G20 commitments and gives an overview of the areas in which inconsistencies, overlaps and conflicts in implementation are causing the greatest difficulty, stemming from factors such as timing differences and super-equivalence or "gold plating". This uneven implementation gives

---

4 The FMLC notes the amendments to Article 1 SEG following the first consultation which require the initial margin to be protected from the default or insolvency of the collecting party *and* any third party or custodian. The FMLC further notes that, where the initial margin is cash and is held with a custodian or third party, custodian or third party credit risk is inevitable. As a consequence, not only does this additional requirement preclude the use of the custodian and charge-back structure in the present example, but it appears to generally preclude the use of a custodian or holding structure. Given the common usage of such structures, the FMLC queries whether this is indeed the intention of the Draft RTS and respectfully requests that it be clarified in the Draft RTS whether initial margin in the form of cash may be held by a custodian or third party, resolving this legal uncertainty.

5 Question 6 invites respondents to comment on the requirements of section 7 concerning the legal basis for compliance.

6 See pages 4, 6, 8 and 12 of the second consultation paper. The internationally agreed standards referred to are those issued by the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions in September 2013 (updated in March 2015) entitled "Margin requirements for non-centrally cleared derivatives".

rise to systemic legal uncertainty,[7] as well as regulatory arbitrage as the more favourable jurisdictions are sought out.

One of the examples of uneven implementation in the G20 Paper arises in the derivatives context in relation to EMIR and the US Dodd-Frank Wall Street Reform and Consumer Protection Act.[8] Moreover, notwithstanding the intentions of the Draft RTS, there is also inconsistent implementation at the international level in the context of the Draft RTS. For example, the second consultation specifically exempts physically-settled foreign exchange contracts from the initial margin requirement "[t]o maintain international consistency".[9] However, physically-settled foreign exchange forwards and swaps remain subject to the variation margin requirement in the Draft RTS. This contrasts with the US approach where physically-settled foreign exchange forwards and swaps are exempted from *both* the initial and variation margin requirements. This illustrates the challenges to ensuring consistent international implementation and the FMLC observes that it is more of an iterative process and journey than an immediate destination, which should be borne in mind when finalising the Draft RTS.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins

Joanna Perkins

FMLC Chief Executive

Copied to: Olivier Guersent, Maria Fabregas Fernandez and Jennifer Robertson of the European Commission and Lars Overby, Guiseppe Gabriel Cardi and Andrea Enria of the EBA.

---

7 For example, in a cross-border context where more than one regime applies to a transaction. The rules of each regime may be different and conflict and there may be no equivalence decision—as a result, the parties may be beset by uncertainty as to how to safely navigate such a course.

8 See Section 1 of the Annex to the G20 Paper on "International Derivatives Regulation".

9 See page 8 of the second consultation paper.