

22 December 2014

Patrick Pearson
Head of Unit G2: Financial Markets Infrastructure
Directorate G: Financial Markets
European Commission
1049 Brussels
Belgium

FINANCIAL
MARKETS
LAW
COMMITTEE

Dear Mr Pearson

Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (the “EMIR”) (the “Draft RTS”)

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 14 April 2014, the European Supervisory Authorities published a consultation paper on the Draft RTS. Herewith please find enclosed the response of the FMLC to that consultation (the “FMLC Response”). The FMLC wishes to draw to the Commission’s attention paragraphs 3.1 – 3.10 (inclusive) of the FMLC Response, which discuss the issue of the compatibility of title transfer collateral arrangements (“TTCAs”) with the requirement under Article 1 SEG (Segregation Of Initial Margins) of the Draft RTS that:

1. Collected collateral as initial margin shall be *segregated from proprietary assets* on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty;

[...]

4. The segregation arrangements shall meet both of the following conditions:

(a) initial margins are immediately available to the collecting entity where the posting counterparty defaults;

(b) the posting entity is *sufficiently protected* where the collecting entity enters bankruptcy or other insolvency proceedings. (Emphasis added).

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

8 Lothbury
London EC2R 7HH
www.fmlc.org

Article 1 SEG relates to the requirement for initial margin to be segregated from proprietary assets but it does not state whether the intention of the segregation requirement is to ensure segregation in fact, rather than in law. Although Article 1 SEG does not prescribe the legal mechanism by which the initial margin must be transferred, the FMLC understands that the express reference to “proprietary assets” in Article 1 SEG has resulted in widespread market perception that the use of TTCAs is not permissible. A TTCA, by definition¹, involves the transfer of title to the collateral taker.² Consequently, assets transferred as collateral pursuant to a TTCA would legally constitute “proprietary assets” of the collateral taker.

There are two possible interpretations of the purpose and scope of Article 1 SEG. If Article 1 SEG requires that initial margin must not legally constitute the proprietary assets of the collateral taker or the collecting counterparty, such initial margin could not be transferred by way of TTCAs. By contrast, Article 1 SEG could merely require an operational segregation of the initial margin, which means that it does not necessarily preclude the use of TTCAs as long as the actual structure of the TTCA used fulfils the operational segregation requirements.

Even though the assets (initial margin) transferred under a TTCA constitute “proprietary assets” of the collateral taker, under certain collateral holding structures, it is possible for such assets to be held on a segregated basis in an account with a third party custodian in satisfaction of an operational segregation requirement. The further requirement under Article 1 SEG that the collateral provider be “sufficiently protected” where the collecting entity enters bankruptcy or other insolvency proceedings could be satisfied by a number of means, including, for example, by way of a charge-back by the collateral taker over its rights to such account in favour of the collateral-provider. Such charge may or may not constitute a financial collateral arrangement within the meaning of the Directive 2002/47/EC of 6 June 2002 on Financial Collateral Arrangements, but may, arguably, provide “sufficient protection” to the provider of the initial margin, within the meaning of Article 1 SEG.

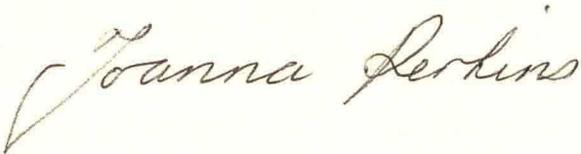
¹ Under a TTCA, the collateral provider transfers legal (and beneficial) ownership in collateral to a collateral taker on terms that when the relevant obligations are discharged the collateral taker must transfer legal (and beneficial) ownership of equivalent financial collateral to the collateral-provider.

² Under English law, this transfer of title is generally effected by way of (i) in the case of “cash” collateral, simultaneous extinction (for the collateral provider) and creation (for the collateral taker) of a *chose in action* as against the bank with whom the relevant account is held, such *chose in action* represented by a debit or credit entry in the relevant account, as appropriate; and (ii) in the case of collateral that are registered securities, (a) registration of the transfer, or (b) otherwise, assignment of the beneficial interest in the securities.

The FMLC wishes to ask the Commission to confirm that the initial margin segregation requirement under Article 1 SEG is not inherently incompatible with the use of TTCAs in the transfer of initial margin. Assuming that the Commission is of the view that TTCAs could be compatible with the relevant requirements, the FMLC finds it desirable that Article 1 SEG be amended to clarify that the purpose of the requirement is operational in nature. The FMLC respectfully requests the Commission to consider the proposals set out in order of preference in Appendix 1. Alternatively, if the Commission wishes to clarify this point by other means, such as by way of the EMIR Questions & Answers, the FMLC would recommend that the Commission provides a statement that the use of TTCAs is not inherently incompatible with Article 1 SEG. It would also be helpful if the Commission could confirm that certain collateral holding arrangements, such as charge-back, would be considered "sufficient protection" for the purposes of the Article 1 SEG.

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

FMLC Chief Executive

Copied to: Lars Overby and Giuseppe Gabriel Cardi, European Banking Authority

Appendix 2

A. Preferred Amendments*Article 1 SEG - Segregation of initial margins*

1. Collected collateral held as initial margin shall be segregated from ~~proprietary~~ other assets ~~on the books and records of a third party holder or custodian, or via other legally effective arrangements made~~ held by the collecting counterparty-, such that it can be effectively distinguished from those other assets.
2. To the extent that collected collateral held as initial margin consists of assets title to which (or, in the case of cash, the right to the repayment of which) is evidenced by entries in an account maintained by the collecting counterparty with an intermediary, the segregation requirement under paragraph 1 shall be satisfied by the holding of such assets in an account which is separate from any account in which other assets are held by the collecting counterparty.
- 2.3. The collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties ('individual segregation').
- 3.4. Where initial margin is collected in cash, it shall be ~~segregated individually~~ individually subject to individual segregation, unless the collecting counterparty can prove to its counterparty and to the competent authority that ~~legally effective arrangements are in place to segregate it from proprietary assets~~ it is held in a manner that complies with paragraph 1.
- 4.5. The segregation arrangements shall meet both of the following conditions:
 - (a) initial margins are immediately available to the collecting entity where the posting counterparty defaults;
 - (b) the posting entity is sufficiently protected where the collecting entity enters bankruptcy or other insolvency proceedings.
- 5.6. At the inception of the transaction and on a regular basis thereafter, and at least annually, the counterparties shall obtain satisfactory legal opinion(s) in all relevant jurisdictions on whether the segregation arrangement meets the requirements set out in ~~paragraph 3 and 4~~ this Article.

B. Alternative Amendments

Article 1 SEG - Segregation of initial margins

1. Collected collateral held as initial margin shall be segregated [from proprietary other assets of the collecting counterparty] on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty.
2. In order to satisfy the segregation requirement under paragraph 1, a third party holder or custodian shall be required to keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the third party holder or custodian collateral collected as initial margin from any other assets (other than collateral collected as initial margin) held for the account of the collecting or the posting counterparty.
- ~~2.3~~ The collecting counterparty shall always provide the posting counterparty with the option to segregate its collateral from the assets of other posting counterparties ('individual segregation').
- ~~3.4~~ Where initial margin is collected in cash, it shall be segregated individually, unless the collecting counterparty can prove to its counterparty and to the competent authority that legally effective arrangements are in place to segregate it from proprietary assets.
- ~~4.5~~ The segregation arrangements shall meet both of the following conditions:
 - (a) initial margins are immediately available to the collecting entity where the posting counterparty defaults;
 - (b) the posting entity is sufficiently protected where the collecting entity enters bankruptcy or other insolvency proceedings.
5. At the inception of the transaction and on a regular basis thereafter, and at least annually, the counterparties shall obtain satisfactory legal opinion(s) in all relevant jurisdictions on whether the segregation arrangement meets the requirements set out in paragraph ~~34~~ and ~~45~~.