FINANCIAL MARKETS LAW COMMITTEE

13 April 2015

Richard Knox
Deputy Director, Securities and Markets
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Mr Knox,

Meaning of "possession", "control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003 ("FCARs")

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.

In December 2012, the FMLC published a paper (the "2012 Paper") which highlighted certain issues of legal uncertainty in relation to the meanings of "possession", "control" and "excess financial collateral" in the FCARs and proposed amendments to the FCARs in order to address these issues.[1]

The FMLC subsequently participated in discussions with HM Treasury with respect to the paper, which culminated in agreement by the FMLC to follow up with further evidence of the impact of the issues of legal uncertainty identified in the 2012 Paper on the transactions and operations of the wholesale financial markets.[2] The FMLC has collected evidence of such impact, both qualitative and quantitative, from wide-ranging sources, including law firms, market participants and financial market infrastructure. This is set out at the bottom of this letter, together with a supporting appendix.

As well as further substantiating the issues of legal uncertainty highlighted in the 2012 Paper, the evidence as a whole demonstrates the *cumulative effect* of such uncertainty on the different parts of the UK financial markets. Impending changes brought about by EU financial regulation also bring renewed concern to this area, as they will result in an increased use of security financial collateral arrangements ("SFCA"), thereby exacerbating the issues of legal uncertainty. It is therefore increasingly critical to the operation of the wholesale financial markets, as well as the systemic stability of its infrastructure, that the issues of legal uncertainty are resolved as proposed in the 2012 Paper.

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

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

8 Lothbury
London EC2R 7HH
www.fmlc.org

"FMLC" and "The Financial Markets Committee" are terms used to describe a committee appointed by **Financial Markets Law Committee**, a limited company. Registered office: 8 Lothbury, EC2R 7HH. Registered in England and Wales: company number 8733443.

1. Impact on the UK security settlement system (CREST)[3]

A large volume of transactions in securities are settled by the CREST system on a daily basis. The daily average securities movements are £871 million (of which £437 million relates to auto-collateralisation) and the daily average cash movements are £657 million (of which £277 million relates to auto-collateralisation).

CREST settlement banks make payments on behalf of CREST members in respect of members' transactions in securities. Many CREST settlement banks have taken security—in practice, a floating charge—over securities in the CREST system to cover their exposure to the value of approximately £4.4 billion of securities.[4] The effectiveness of the settlement banks' security arrangements depends on the constitution of a SFCA, benefitting from the protections of the FCARs.

2. Legal enforceability

The FMLC understands that, given the severe consequences of a failure to register, the general market practice is to continue to register charges over collateral, notwithstanding the provisions of the FCARs.[5]

3. Difficulties with the issue of English legal opinions

The FMLC understands from its discussions with law firms that uncertainty in respect of the meanings of "possession", "control" and "excess financial collateral" means that firms rarely issue "clean" legal opinions that a security arrangement constitutes a SFCA.[6]

Legal opinions typically contain reservations (which may be substantial) and the market participant to whom the opinion is addressed will bear the legal risk of a security arrangement failing to be characterised as a SFCA.[7] This has a bearing on the decision-making of market participants and how financial transactions are structured.

4. Impact on the non-centrally cleared OTC derivatives market

Impending regulatory changes brought about by Regulation (EU) No. 648/2012 ("EMIR") will cause an increase in the use of SFCAs. The draft regulatory technical standards on risk-mitigation techniques for OTC-derivatives not cleared by a central counterparty (a "CCP") under Article 11(15) of EMIR contain the requirement that an entity posting initial margin is sufficiently protected in the event of the insolvency of the collecting counterparty. A title transfer collateral arrangement ("TTCA") may not be compatible with this requirement because it involves a transfer of title to the initial margin to the collecting counterparty.[8] However, the requirement can be met using a SFCA. While current market practice is to use a TTCA, EMIR will likely necessitate a switch to SFCAs.[9]

Taking into account changes introduced by EMIR, the estimated value of total gross notional outstanding for non-centrally cleared derivative activities is about EUR 74.9 trillion.[10] The size of the non-centrally cleared derivatives market, coupled with the change in market practice referred to above, will have a significant systemic impact on the wholesale financial markets: market participants will need to use SFCAs with their incumbent uncertainties.

For further detail and statistics, please refer to the attached appendix dated July 2014 (the "EMIR Appendix"), which you have previously received on an informal basis.

5. Impact on the centrally cleared OTC derivatives market

The volume of derivatives transactions that are subject to central clearing is already extremely large. For example, at close of business 18 June 2008, the notional outstanding

amount of transactions cleared by Swapclear was USD 14 trillion.[11] This volume will increase as a result of EMIR because it requires more transactions to be centrally cleared.[12]

Regulation (EU) No. 575/2013 (the "CRR") has introduced a regulatory capital charge for exposures to CCPs, unless the assets posted to a CCP by way of initial margin are insolvency remote in the event of the CCP's insolvency. As set out above, insolvency remoteness may not be able to be achieved using a TTCA and a SFCA may therefore be required to avoid the regulatory capital charge.

The changes effected by EMIR and the CRR will therefore result in an increase in SFCAs and a corresponding increase of uncertainty in respect of SFCAs. Taken together with the size of the centrally cleared derivatives market, this will also have a substantial effect on the wholesale financial markets. Please see the EMIR Appendix for further details and statistics.

---

1 FMLC, "Analysis of uncertainty regarding the meaning of 'possession or ... control' and 'excess financial collateral' under the Financial Collateral Arrangements (No. 2) Regulations 2003" (December 2012). http://www.fmlc.org/uploads/2/6/5/8/26584807/0112121.pdf

2 On 13 September 2013, representatives of the FMLC: Joanna Perkins, Simon Firth, Habib Motani and Geoffrey Yeowart held a meeting with David Beardsworth of HM Treasury. On 28 October 2014, representatives of the FMLC: Simon Firth, Geoffrey Yeowart and Jennifer Enwezor held a conference call with Stephen Parker, Jonathan Edwards and Catherine Ray, all of HM Treasury.

3 The figures in this section were provided by Euroclear UK & Ireland ("EUI"). These figures are based on aggregate figures taken from the CREST system. Actual figures can vary considerably day to day.

4 The total aggregate amount of secured caps is £52 billion (the average secured cap is £1.2 billion). The average credit exposure is £630 million and the average value of securities subject to a charge is £1.2 billion. The number of security deeds (containing floating charges) given by CREST members to CREST settlement banks and pre-lodged with EUI under the fast track enforcement procedure stands at approximately 40.

5 A specific example of this is clearing houses which frequently require members to post initial margin by way of a security arrangement. Notwithstanding the FCARs, the clearing houses still require the security arrangements to be registered. The requirement to register is not just restricted to English law governed charges granted by companies incorporated in England and Wales but also includes any foreign law governed charges granted by such companies.

6 On 12 February 2014, Simon Firth and Richard Hay of Linklaters provided the FMLC with a memorandum, analysing in detail such difficulties and comparing the position in the UK with other jurisdictions in the EU, where there is greater certainty with respect to SFCAs. A copy of this memorandum may be provided to HM Treasury on request.

7 Excerpts of such legal opinions may be provided to HM Treasury on request.

8 FMLC, "Report on Legal Uncertainties Arising from the Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts no Cleared by a CCP under Article 11(5) of Regulation (EU) No 648/2012" (14 August 2014). http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc - response to consultation on draft rts on ....pdf

9 FMLC, "Letter to the European Commission on Legal Uncertainties Arising from the 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" (22 December 2014) http://www.fmlc.org/uploads/2/6/5/8/26584807/letter to mr patrick pearson european commission.pdf.

10 The Consultation Paper (the "Consultation Paper") published by the European Supervisory Authorities containing a draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP, p. 56. A significant proportion of this is likely to be represented by transactions entered into by counterparties based in the United Kingdom.

11 As published by Swapclear (which is partly based in the UK and partly in the US), which publishes on a daily basis the global volume of transactions that are cleared by it. See www.swapclear.com/what/clearing-volumes/html.

12 The Consultation Paper states that (i) the estimated value of total gross notional outstanding for non-centrally cleared derivative transactions is about EUR 146 trillion and (ii) this will decrease to about EUR 74.9 trillion after the implementation of the central clearing obligation. There will therefore presumably be a corresponding increase in respect of centrally cleared derivative transactions.

APPENDIX
FINANCIAL MARKETS LAW COMMITTEE
ISSUE 01:[1] COLLATERAL DIRECTIVE
[...] JULY 2014

THE IMPORTANCE OF SECURITY FINANCIAL COLLATERAL ARRANGEMENTS IN THE FINANCIAL MARKETS

1. Background

EU Regulation No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") contains a series of measures that are designed to limit the extent to which systemic risks are capable of building up in the financial markets. One of the key measures is an obligation to clear certain OTC derivatives via a central counterparty (a "**CCP**"). This will, however, apply only to transactions falling within a class specified by the European Supervisory Markets Association ("**ESMA**"). Other transactions (in particular, those which are not entered into on standard terms) will not be subject to central clearing.

To mitigate the risks associated with these other transactions, EMIR imposes a number of operational requirements. They include a requirement for certain entities that are active in the OTC derivatives market to have procedures that require the "timely, accurate and appropriately segregated exchange of collateral" with respect to non-cleared OTC derivatives (Article 11(3)).

This appendix considers the impact that this requirement is likely to have on the collateral arrangements that are used in the derivatives market. It also sets out the evidential basis for the proposition that the Financial Collateral Arrangements (No 2) Regulations 2003 should be amended in line with the FMLC's paper of December 2012 titled "Analysis of uncertainty regarding the meaning of "possession or .. control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003".

---

[1] The FMLC is very grateful to Simon Firth and Ursula Williamson of Linklaters LLP for their contributions to this appendix.

2. Segregation of Initial Margin for Uncleared Transactions

The European Supervisory Authorities have been mandated to develop common regulatory technical standards ("**RTS**") that set out the detailed requirements that will apply to the exchange of collateral in respect of non-centrally cleared OTC derivatives. In April 2014, it published a Consultation Paper containing a draft RTS (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 dated 14 April 2014) (the "**Consultation Paper**"). A final draft of the RTS (taking account of any feedback from the consultation), is expected to be submitted to the Commission before the end of 2014, with the draft RTS expected to take effect from 1 December 2015.

Of particular relevance are the operational provisions regarding initial margin, which will apply to new contracts not cleared by a CCP. These requirements will be phased in from 1 December 2015, with full implementation by 1 December 2019. Under Chapter 4, Article 1 (*SEG*-Segregation of Initial Margins) of the draft RTS, collateral collected as initial margin will have to 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".

The arrangements will also be required to meet the following conditions:

(i) the initial margin must be immediately available to the collecting entity where the posting counterparty defaults; and

(ii) the posting entity must be "sufficiently protected" where the collecting entity enters bankruptcy or other insolvency proceedings.

Under English law, the only feasible way of ensuring that the requirements of limb (ii) are met would be for a security interest over the initial margin to be created in favour of the collateral taker. This will represent a fundamental change in market approach. Currently, the collateralisation of derivatives transactions using documentation governed by English law (which principally comprises the Credit Support Annex to the ISDA Master Agreement, published by the International Swaps and Derivatives Association) typically involves a transfer of title to the collateral to the collateral taker. This change in approach means that it will be critical to ensure that the security arrangements that are used are legally enforceable. Given the size of the market, as described in paragraph 3

below, any uncertainty about this could have systemic implications, thereby undermining one of EMIR's key objectives.

3. Size of the Market for Uncleared Transactions

3.1. Introduction

The Consultation Paper includes an impact assessment, which contains a quantitative analysis of, inter alia, the value of non-centrally cleared derivatives in the EU market and the likely impact of the RTS on the collection of initial margin. These statistics are described as being "based on the most recent comparable data".[2] The figures are based, in part, on the BCBS-IOSCO quantitative impact study on margins relating to international coverage following their quantitative survey in July 2012, the results of which were published together with the revised version of the international standards.[3]

3.2. Impact of central clearing

The Consultation Paper states that:

> *currently, the estimated value of total gross notional outstanding for non-centrally cleared derivative activities is about EUR 146 trillion. This figure is expected to decrease to about EUR 74.9 trillion (or by 49%) after the implementation of the central clearing obligation, which will require about half of these transactions to be subject to mandatory central clearing. In other words, after the implementation of the margin requirements, about 49% of the OTC derivatives market will be captured by the current RTS, and the remaining 51% will be cleared centrally.*[4]

3.3. Initial margin requirements

As regards the market for non-centrally cleared OTC derivatives transactions following the implementation of the clearing obligation, the Consultation Paper concludes that: "the overall estimate of initial margin requirements for the EU ranges from EUR 200 billion to EUR 420 billion."[5]

---

2 Consultation Paper, p.72.

3 Margin requirements for non-centrally cleared derivatives – second consultative document, issued by BCBS and IOSCO in February 2013.

4 Consultation Paper, p.56.

5 Consultation Paper, p.74.

Given the relative size of London as a financial centre, a significant proportion of this is likely to be represented by transactions entered into by parties based in the United Kingdom.

4. Cleared Transactions

4.1. Regulatory capital requirements

The EU Capital Requirements Regulation (Regulation 575/2013 of 26 June 2013) has introduced a regulatory capital charge for exposures to CCPs. A 2 per cent risk weight applies to assets posted to a CCP by way of initial margin unless the assets are bankruptcy remote in the event of the CCP's insolvency, in which event a 0 per cent risk weight applies (Article 306). For the reasons set out in paragraph 2 above, bankruptcy remoteness cannot be achieved via a title transfer arrangement. Accordingly, to avoid the imposition of a regulatory capital charge, institutions must ensure that any initial margin posted by them is provided by way of security (with the CCP having no right of reuse). In any event, most margin arrangements involving CCPs involve the creation of a charge over any initial margin they receive.

4.2. Size of the market for cleared transactions

The volume of derivatives transactions that are subject to central clearing is already extremely large. For example, Swapclear (which is partly based in the UK and partly in the US) publishes, on a daily basis, the global volume of transactions that are cleared by it.[6] At close of business on 18 June 2008, the notional outstanding amount of transactions cleared by it was US$14 trillion.

4.3. Future trends

As noted in paragraph 3.2 above, the European Supervisory Authorities have estimated that the total gross notional amount outstanding of non-centrally cleared derivative transactions is approximately €146 trillion. This is estimated to decrease to about €74.9 trillion as a result of the implementation of the clearing obligation under EMIR. It

---

6 www.swapclear.com/what/clearing-volumes/html

follows that there will be a corresponding increase in the volume of transactions that are cleared through a CCP.

5. Conclusions

The following conclusions can be drawn from the above analysis:

(a) with effect from 1 December 2015, initial margin in respect of OTC derivatives transactions that are not subject to the clearing obligation will have to be provided on a "bankruptcy remote" basis;

(b) in practice, this means that it will have to be provided by way of security;

(c) this will require a change in market practice, since, at present, collateral in the UK OTC derivatives market typically involves title transfer arrangements;

(d) the volume of transactions that will be affected is very large: €200-420 billion of initial margin is estimated to be outstanding following the introduction of the new rules;

(e) security will also be used in the market for cleared transactions, partly because this will enable institutions to avoid the regulatory capital charge that would otherwise apply and partly because it reflects the structure of the CCPs' margining arrangements;

(f) the volume of cleared transactions in the EU is already very large and, following the implementation of the clearing obligation under EMIR, is expected to increase by around €71 trillion;

(g) in view of this, it will be critical to ensure that the security arrangements are enforceable—any uncertainty on the point will have systemic implications.