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Dear Sirs

Issue 176: Non-bank Resolution – Response to HM Treasury consultation entitled Amendments to the recognition requirements for investment exchanges and clearing houses (PU1442, January 2013)

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

The above consultation (the "Consultation") requests comments on two new requirements proposed to be inserted into the Recognition Requirements for Investment Exchanges and Clearing Houses (the "Recognition Requirements").[1] The new requirements are intended to apply to UK recognised clearing houses providing central counterparty ("CCP") services.

One of the new requirements is that a CCP has in place a recovery plan to help maintain the continuity of its services in the event that such continuity is threatened. The second of the new requirements covers loss allocation and it is with that requirement that the remainder of this letter is concerned.

The Consultation proposes an amendment to the Recognition Requirements which would require that CCPs have rules and arrangements to allocate uncovered losses amongst members and other related parties. The amendment states as follows

> A central counterparty must have in place within six months of these Regulations coming into force—
>
> (a) rules to allocate losses that arise as a result of member default that remain after the resources to which the central counterparty has access (pursuant to paragraph 16 [of this schedule] or Article 45 of the OTC derivatives, central counterparties and trade repositories regulation, as relevant at the time) are exhausted; and
>
> (b) effective arrangements (which may include rules) to allocate losses that arise otherwise than as a result of member default; such that these rules and arrangements ensure that the central counterparty may, consistent with its statutory obligations (including, where relevant, the OTC derivatives, central counterparties and trade repositories regulation),

[1] The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations. 2001 No. 995.

allocate losses capable of threatening its financial viability, with a view to the central counterparty being able to continue to provide clearing services.

The Consultation acknowledges that proposals concerned with the recovery and resolution of "financial market infrastructures" ("FMIs") have been developed by the Financial Stability Board, the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions ("CPSS-IOSCO") and DG Markt of the European Commission.[2]

In this context, the FMLC wishes to raise briefly the following contextual issues linked to the proposed amendments to the Recognition Requirements which may give rise to legal uncertainty.[3]

One can identify two types of system for loss allocation, both of which are contemplated by CPSS-IOSCO: a system based on action by the relevant FMI and a system based on action by the resolution authority. The FMLC notes that it is important that certainty exists as to the status and interaction of measures taken by the FMI—pursuant, for example, to rules or arrangements made under the proposed new requirement—and measures taken by the resolution authority in this regard.[4]

The proposals published by CPSS-IOSCO in this area may be considered as fairly broad and still under development.[5] However, the Consultation states that CCPs will be expected to be guided by the work of CPSS-IOSCO when fulfilling the new requirements. In this context, the FMLC notes that there may be a proliferation of divergent and sub-optimal loss allocation arrangements.

The FMLC suggests that the provision of further guidance as to what is and is not permissible in terms of loss sharing with clearing members—given the cap on a member's exposure under the second sentence of Article 43(3) of EMIR and the limitation on use of a non-defaulting member's collateral under the second sentence of Article 45(5) of EMIR—could provide for greater legal certainty.

The FMLC believes that it may also increase certainty if the requirement for the putting in place of loss allocation arrangements and rules is phased in after the requirement for the production of rescue and resolution plans by FMIs. It would appear important that the transition period be long enough to enable CCPs to consult with their clearing members in relation to the changes to existing rules and procedures necessary to meet the proposed requirement. The FMLC understands that loss allocation is likely to raise issues of major interest for clearing members. A CCP will need to develop proposals, consult clearing members and then settle proposals in light of that consultation and after discussion with the regulator.

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2 See IOSCO's Recovery and resolution of financial market infrastructures consultation and Principles for financial market infrastructures, the FSB's Key attributes of effective resolution regimes for financial institutions and the consultation from DG Markt.

3 Some of these concerns are discussed in the responses to the CPSS-IOSCO consultation paper on this subject.

4 A CCP will normally have extensive powers under its default rules (which are protected by Part VII of the Companies Act 1989 and by the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 or "the Settlement Finality Regulations") to deal with the consequences of a default by a member. These will typically include a power to close out or hedge open positions of the defaulting member or to carry out an auction amongst non-defaulting members of open contracts of the defaulting member. Clients of a defaulting member might also request their client accounts to be ported to a non-defaulting member (as contemplated by Article 48 of the European Market Infrastructure Regulation "EMIR"). If there were an excess loss after exhausting the collateral and default fund contributions of the defaulting member, the CCP would be required to use its own dedicated resources and default fund contributions of non-defaulting members (as contemplated by Article 45 of EMIR). It is possible that, if a resolution authority were to step in, the CCP might be in the midst of implementing its default arrangements in relation to a defaulting member. It needs to be clear that, if this happened, it would not have an adverse impact on the orderly operation of default arrangements which had already been activated.

Further, if the possibility of a CCP's own failure is to be addressed, it may well be necessary to review Part VII of the Companies Act 1989 and the Settlement Finality Regulations to identify whether any consequential or other amendments might be appropriate.

5 The European Commission, for its part, does not anticipate adopting a legislative proposal on this subject until the fourth quarter of 2013. See the Commission's work programme here.

The FMLC notes that it is also important to consider how the loss allocation arrangements of a CCP might impact other FMIs, such as central securities depositories, and financial institutions linked to them.

Further, the FMLC notes that loss allocation rules and arrangements may give rise to uncertainty caused by inconsistency with competition law.

Please do not hesitate to contact me should you wish to discuss the issues raised in this letter further.

Yours faithfully

Joanna Perkins
FMLC Director