ISDA Safe, Efficient Markets

21 November 2013

Contingency Planning Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Sent by email: non-bank.resolution@hmtreasury.gsi.gov.uk

Re: HM Treasury Open consultation on Secondary legislation for Non-Bank resolution regimes

Ladies and Gentlemen:

This letter contains the response of the International Swaps and Derivatives Association, Inc. (**ISDA**)[1] to the HM Treasury Open consultation on Secondary legislation for Non-Bank resolution regimes published 26 September 2013 (the **Consultation**). For the purposes of this response we focus our comments primarily on the aspects of the Consultation that concern central counterparties.

We appreciate the opportunity to share these comments and would be pleased to engage further with HM Treasury on this regulatory initiative. If you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

George Handjinicolaou, Ph.D

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[1] Information regarding ISDA is set out in Annex 1 to this response.

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Response to individual questions in relation to central counterparties

In responding to these questions, we have referred to:

1. The Banking Act 2009 (Exclusion of Investment Firms of a Specified Description) Order 2013 (Annex A to the Consultation) as the **Draft Investment Firms Order**;

2. The Banking Act 2009 (Banking Group Companies) Order 2013 (Annex B to the Consultation) as the **Draft Banking Group Companies Order**;

3. The Banking Act 2009 (Restriction of Partial Property Transfers) (Recognised Central Counterparties) Order 2013 (Annex C to the Consultation) as the **Draft CCPs Order**; and

4. The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) (Amendment) Regulations 2013 (Annex D to the Consultation) as the **Draft Compensation Regulation Amendment**.

Question 1 *Do you have any specific recommendations for required updates in the Code of Practice?*

In light of the impending EU Recovery and Resolution Directive (the **draft BRRD**) and potential legislation for FMI recovery and resolution (**FMI RRD**), it is important that the UK Authorities ensure that matters which are specifically provided for in such European law are reflected in UK law, and not solely in the Code of Practice. Although the Authorities are obliged to have regard to the Code of Practice, it is non-binding guidance and thus should not be used to implement aspects of EU law. Specifically, we note that the draft Annex to the Code of Practice, released with HM Treasury's proposed amendments to the Financial Services (Banking Reform) Bill 2012-2013 and 2013 – 2014 (the **Banking Reform Bill**) for the purposes of introducing a new bail-in stabilization option[2], includes at paragraph 8.14 the following statement regarding bail-in of *inter alia* derivatives: "the Bank of England's expectation is that, to the extent that such contracts are bailed in, those contracts will be closed out before they are bailed in." Article 44.1a of the Council's 28 June 2013 general approach text of the draft BRRD[3] states: "Resolution authorities shall exercise the write-down and conversion powers in relation to a liability arising from a derivative only upon or after closing-out the derivatives. Upon entry into resolution, resolution authorities shall be empowered to terminate and close out any derivative contract for this purpose." As this is expressed as a requirement under the draft RRD, ISDA is of the view that it should be embedded as a requirement in the Banking Act. The approach of including this requirement as a regulatory expectation in the Code does not give the market adequate certainty as to the manner in which a derivative contract might be bailed-in.

The Code of Practice could, to the extent that HM Treasury decides not provide the necessary detail in the Act or the draft Orders, be used to provide clarity as to the:

- circumstances in which a partial property transfer (**PPT**) might be appropriate for a CCP;
- what might sensibly be subject to a PPT in the context of a CCP; and
- points in the default waterfall at which a resolution action might be appropriate, if the Authorities do not choose to clarify this in the Act.

[2] Available at: https://www.gov.uk/government/publications/banking-reform-bill-government-notes-on-amendments

[3] Available at: http://register.consilium.europa.eu/pdf/en/13/st11/st11148-re01.en13.pdf

In relation to the second and third of these points in particular, please see our response to Question 23 below.

When the Code of Practice is updated to reflect the new amendments to the Banking Act, the Orders proposed in the Consultation and the approach to resolution of CCPs, ISDA would welcome further consultation with HM Treasury before the CCP-related changes are finalised.

Question 2 *Do you have any further comments concerning updating the Code of Practice?*

Given the significant differences between CCPs and banks / investment firms, particularly in a resolution context, and for the sake of clarity, we would urge HM Treasury to produce a separate Code of Practice which seeks to address CCPs alone rather than looking to apply the existing Code by extension and modification of provisions not necessarily suited to CCP issues.

ISDA would welcome the opportunity to comment on CCP-related updates to the revised Code of Practice when still in draft form, whether through its involvement in HMT's Banking Liaison Panel or otherwise.

Question 3 *Do you agree with excluding all non-730k investment firms from scope?*

ISDA makes no comment in response to question 3.

Question 4 *Do you feel this is the correct threshold, bearing in mind that the regime will be applied in a proportionate manner to those firms in scope?*

ISDA makes no comment in response to question 4.

Question 5 *Do you agree with the proposed specification of firms to be considered banking group companies?*

ISDA would make the following points in response to Question 5.

1. Regulatory discretion in the definition of a "banking group company" creates legal uncertainty, is unhelpful and unnecessary.

The allowance for regulatory discretion in the definition of a "banking group company" (see Article 3(5) of the Draft Banking Group Companies Order) creates legal uncertainty, which is unhelpful and unnecessary. In considering the application of the Banking Act, interested stakeholders for the purposes of any credit risk analysis, and the banking group itself for the purposes of resolution planning, will be required to apply the widest possible interpretation of "banking group company" even if the likelihood that a particular company would be considered by the Bank of England to be within scope is remote. In this regard, the definition of "banking group company" departs from HM Treasury's policy objective, as stated in the "Financial sector resolution: summary of responses" paper dated October 2012[4] that conditions for test of a "banking group company" "will require groups to be identified by reference to the lowest level of holding company".

2. Particularly in the context of CCPs, the definition of "banking group company" may encompass other financial market infrastructure entities, which is not a desirable policy outcome

The definition of 'financial holding company', as set out in Article 1(2) of the Draft Banking Group Companies, refers to the parent company of a group with subsidiaries which are "exclusively or mainly" banks, investment firms, insurance companies, investment exchanges, CCPs or financial institutions, and

[4] Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190259/condoc_financial_sector_resolution_broadening_regime_responses.pdf.

undertakings which have the main or exclusive purpose of providing services or facilities to group companies. A "financial holding company" and all of its subsidiaries are potentially within scope of the "banking group company" definition.

ISDA acknowledges that there may be group service companies and intra-group reliances that should be within the scope of the Banking Act powers for the purposes of addressing a CCP resolution. However, we also note that UK CCPs may well have in their groups companies which carry on the business of other non-CCP financial market infrastructure (**FMI**) e.g. recognized investment exchanges, settlement systems and payment systems, or indeed possibly other UK-based CCPs.

We do not think that it is desirable that such FMI should in principle be within the scope of "banking group companies" in respect of whom Banking Act powers might be exercised in the context of the CCP's resolution (even if relevant safeguards would reduce the likelihood of their ever being affected).

We note also that for non-CCP FMI, these are not themselves within scope of the Banking Act and HM Treasury has previously stated that the authorities "will consider how best to move forward and implement the changes if appropriate". It is important that the extension of the Banking Act to Banking Group Companies and CCPs does not inadvertently operate to extend the scope of the Banking Act to non-CCP FMI, in circumstances where there has not been full consultation and disclosure of the powers and safeguards that will be relevant in the context of non-CCP FMI resolution. ISDA therefore recommends that Article 2(3) of the Draft Banking Group Companies Order be amended as follows:

2.—(3) The business of the undertaking must not be wholly or mainly—

…

(b) to guarantee the performance of obligations of a party to a capital market arrangement; ~~*or*~~

(c) to provide security for the performance of obligations of a party to a capital market arrangement~~.~~*;* *or*

(d) operation of one or more trading venues as a "recognised investment exchange" (as defined in section 285 of FSMA), business carried on as a "designated system" as defined in Article 2 of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999, business carried on as a "recognised auction platform" as defined in Article 1(3) of The Recognised Auction Platforms Regulations 2011, or any combination of such activities.

3. The reference to the Banking Consolidation Directive will shortly be obsolete

The definition of "financial institution" presently refers to the Banking Consolidation Directive, which will shortly be superseded by the new Capital Requirements Directive (Directive 20134/36/EU) (**CRD**) and Capital Requirements Regulation (Regulation EU No. 575/.2013) (**CRR**). It may therefore be more appropriate for "financial institution" to be defined by reference to the "financial Institution" definition in point 26 of Article 4(1) of the CRR (which cross-refers to paragraphs 2-12 and 15 of Annex 1 to the new CRD).

4. The proposed definition of "financial holding company" may risk confusion

ISDA notes that "financial holding company" is already a term defined in the Financial Services Handbook and used for other purposes, and that the definition in the Draft Banking Group Company Order differs from that Financial Services Handbook definition. This risks potential confusion. It may be appropriate therefore either (i) to use a different defined term for the purposes of capturing this concept in the proposed legislation,

or (ii) to use the term "financial holding company" in line with the definition used in the Financial Services Handbook and then extend it in the proposed legislation to capture those elements which are not caught within the current scope of the concept, i.e. in particular group service companies and CCP groups.

Question 6 *If you disagree, how would you prefer the specification to be approached?*

See response to Question 5 above.

Question 7 *The definition of 'financial holding company' is set in relation to its subsidiaries being exclusively or mainly of a particular type eg entities engaged in financial services and entities exclusively or mainly providing services or facilities to those entities. Do you think the use of 'exclusively or mainly' provides adequate clarity in the definition of a financial holding company, and therefore the scope of the SRR in relation to banking group companies?*

ISDA notes that the Financial Services Handbook definition of "financial holding company" uses the phrase "exclusively or mainly". Therefore, in the event that the relevant definitions are more closely aligned with those in the Financial Services Handbook, as suggested in response to Question 5 above, this should be generally well understood and thus provides appropriate clarity.

Question 8 *Do you think the capital markets arrangements exemption is required in this order?*

As a general matter, a "capital markets arrangement" exclusion of the kind contemplated by Article 2(3) is appropriate and necessary in the Draft Banking Group Companies Order. Other respondents, such as the European Covered Bonds Council, will be better placed to comment on the precise wording of the exemption.

Question 9 *If this exemption is necessary, are the current provisions framed in a sufficiently powerful but flexible way as to provide legal certainty?*

Please see our response to Question 8 above.

Question 10 *Are there other entities you would wish to see excluded? If so, what are they and why should they be excluded?*

Please see our response to Question 7 above.

Question 11 *Do you have any views on how the specifications are framed in the draft order?*

Please see our response to Question 7 above.

ISDA notes that the approach provided for under the primary legislation, namely that "bank" is to be read as including or referring to an investment firm or CCP as the context requires which consequently requires that the definition of a "banking group company" must also work for investment firm group companies and CCP group companies, makes the legislation difficult to follow and risks uncertainty. While it is appreciated that the primary legislation cannot now be amended, it may be preferable for the Draft Banking Group Companies Order to specify different conditions as to the make-up of a group in the context of each of a bank, investment firm or CCP. We would be happy to provide drafting to implement this alternative approach (i.e. alternative to the current approach, as amended by our comments at Question 7 above) if that would be helpful.

ISDA notes that the proposed amendment to the Banking Act 2009 (Restriction of partial Property Transfers) Order 2009 (the **2009 Order**) provided for in Article 4(3) of the Banking Group Companies Order, restricts the application of a partial property transfer (**PPT**) order in respect of a banking group companies to property or rights of the banking group company that are "necessary for the carrying on of the business of the [failing]

bank" (or, in the context of this response, CCP). This restriction is welcome. ISDA further considers that the carve-out of parent undertakings of the failing "bank" (or CCP) from this restriction is appropriate in light of the expected property and rights of such a parent undertaking and the resolution actions likely to be taken with respect to a parent undertaking (subject to our points in Question 5 above); in other words, a resolution of a parent undertaking may sensibly seek to transfer one or more subsidiaries of the parent undertaking, which may or may not be necessary for the carrying on of the business of the failing bank (or CCP).

Finally, ISDA notes that the breadth of application of the "banking group company" definition, which will include entities that do not have any authorization to engage in financial services activities, and which may not be independently verifiable as "banking group companies" by a third party (e.g. a counterparty or contract party) means that any insolvency opinion or netting opinion in respect of any company incorporated in the UK which has in its corporate group an entity engaged in any financial services business will require either (a) an assumption that the relevant entity is not a "banking group company", if there are good objective facts to support such an assumption, or (b) a qualification to the opinion in the event that the relevant entity was a "banking group company". There will necessarily be an impact on the wider market, associated with these changes, in connection with obtaining new opinions to reflect this scope of a "banking group company".

Question 12 *Do you think extending the existing PPT order, as it stands, to investment firms is sufficient?*

ISDA makes no comment in response to Question 12.

Question 13 *Are there further safeguards you would like to see in place and why?*

ISDA makes no comment in response to Question 13.

Question 14 *Do you feel sufficient protection is provided for clients in line with the new client protection objective of the resolution regime?*

It is understood that the new client protection objective referred to is the Objective provided for in Section 4(8) of the Banking Act 2009, as follows:

> *Objective 6, which applies in any case in which client assets may be affected, is to protect those assets.*

"Client assets" is defined in section 3 of the Banking Act 2009 as meaning "assets which an institution has undertaken to hold for a client (whether or not on trust and whether or not the undertaking has been complied with)".

ISDA would welcome consideration by HM Treasury of:

(i) the interaction between the new client protection objective and the client protection safeguards of EMIR, relating to porting or return of client assets upon the default of a clearing member of a CCP (which may precede CCP failure); and

(ii) consideration of the latter EMIR client protection provisions in the application of the resolution regime to CCPs.

ISDA is of the view that (consistent with our response to Question 24 below) the client protection actions of porting or return of client assets, which a CCP is required to be empowered to apply as part of its default procedures, should be applied as a recovery action, i.e. the resolution authorities would not intervene until after such actions had been exhausted. It would be helpful if HM Treasury would confirm that this is its

policy intention and provide appropriate clarification in the expected amendments to the Code of Practice. If this is the policy intention, ISDA is of the view that sufficient protection is provided for clients.

ISDA would particularly welcome the opportunity to comment on this aspect of the CCP-related updates to the revised Code of Practice when still in draft form.

Question 15 *In the 2009 Order the definition of title transfer collateral arrangements requires that both the collateral-provider and collateral-taker are non-natural persons. Should this definition be amended to include title transfer collateral arrangements entered into by real persons?*

ISDA would welcome the extension of the protection for title transfer financial collateral arrangements to include those arrangements entered into by real persons.

Question 16 *Are there any practical considerations that the government will need to address to ensure these safeguards work as planned?*

In the context of investment firms, relevant practical considerations will largely follow those that are relevant in the context of a bank.

ISDA would welcome the opportunity to comment, in relation to the practical considerations that the government will need to address to ensure these safeguards work as planned, on any update to the revised Code of Practice when still in draft form and prior to publication.

Question 17 *Do you agree there should be a broad safeguard to limit PPT powers over the assets of a BGC that are not involved in the business of the failing entity?*

ISDA welcomes the safeguard restricting PPT powers over the assets of "banking group companies" (including in the context of CCP group companies), as defined, where such group companies are not involved in the business of the failing CCP.

We would however reiterate our points made in Question 5 above as they relate to CCP groups and other FMI. We believe it would be preferable for any legislation to make clear beyond doubt that CCP group companies which are themselves FMI are excluded entirely from scope, rather than likely to be excluded in practice by operation of the safeguard.

There may also be a concern as to the potential exercise of the PPT powers over the assets of a company which is in a group that includes a (failing) CCP and, say, a recognized investment exchange (**RIE**) or other FMI where the relevant assets are used to provide services to both the CCP and the other FMI. It will be critical that the other FMI continue to have access to those services, and related assets, following any resolution of the failing CCP. The continuity provisions currently in the Banking Act 2009 and which apply to group companies in the case of a PPT only apply to ensure that group companies provide such "services and facilities as are required to enable the transferee to operate the transferred business, or part of it, effectively" (Section 63) – those provisions do not allow for circumstances where a critical function might be performed by a group company and the relevant group company will require continued access to services and facilities that have been transferred under the PPT. To address this, either:

(i) property and rights which are used by any other group company to perform a critical function should also be excluded; or

(ii) the Act should be amended so as to require the transferee to provide (former) group companies with required services and facilities, where appropriate.

Question 18 *Are there any other type of assets that you feel should be excluded?*

See response to Question 17 above.

Question 19 *Do you agree with the proposed action to be taken following breach of the new safeguards?*

In the context of the new safeguard, which operates to limit the scope of property and rights that may be transferred as part of a PPT with respect to a banking group company, ISDA is of the view that the proposed action to be taken following a breach is appropriate, subject to our comments in response to Question 17 regarding the need for services and facilities to be required to be made available to (former) group companies.

Question 20 *Do you have any views on how the new safeguard is framed in the draft order?*

See comments in response to Questions 11 and 17 above.

Recovery mechanisms must not challenge accounting criteria which clearing members must satisfy themselves of in order to net cleared exposures for financial statement and regulatory capital purposes. Where the specific requirements are not demonstrated, cleared exposures would need to be reported on a gross basis, thereby defeating the purpose of central clearing and consequently rendering clearing nonviable. On the basis that the existing safeguards in the 2009 Order must also apply (i.e. in addition to the new safeguard) in the context of a PPT with respect to a banking group company, and subject to our comments below, ISDA expects that the new safeguard is appropriately framed.

As drafted (Article 4(3) of the Banking Group Companies Order), the new safeguard suggests that there is no circumstance in which the liabilities of a Banking Group Company, which is not the parent undertaking of a bank (defined to include CCPs) may be transferred:

> "*A partial property transfer to which this Order applies may not transfer property, rights or liabilities of a banking group company unless the property or rights are necessary for the carrying on of business of the bank.*"

Given the existing safeguards for netting and set-off, which are essential, ISDA queries whether the new safeguard as drafted will allow the Authorities adequate scope to use the transfer powers as they are intended. There may be circumstances in which property that is critical for the provision of services to the bank, investment firm or CCP is subject to a set-off arrangement encompassing liabilities of the banking group company. Further, if no equivalent amount of liabilities can be transferred, the provision must operate to require that a purchaser may have to pay a cash amount for Banking Group Company assets, which might limit the scope for available purchasers.

ISDA therefore suggests the following amendment to the safeguard:

> *"A partial property transfer to which this Order applies may not transfer property, rights or liabilities of a banking group company unless (i) the property or rights are necessary for the carrying on of business of the bank, (ii) the property, rights or liabilities are part of a netting arrangement, set-off arrangement or title transfer collateral arrangement which includes property or rights that are necessary for the carrying on of business of the bank, or (iii) the liabilities are secured by property or rights that are necessary for the carrying on of business of the bank. "*

Question 21 *Do you agree with the proposed carve out for banking group companies which are a parent undertaking of the bank?*

Yes. See response to Question 11 above.

Question 22 *Do you agree with the approach of issuing a new order specifically concerning the resolution of CCPs?*

ISDA welcomes the approach of issuing a new order specifically concerning CCP resolution in the interests of clarity, rather than subsuming CCP resolution provisions into the original 2009 order.

Question 23 *Is the protection of netting at the level of a CCP's segregated business lines (and the default waterfall associated with each segregated business line) appropriate?*

ISDA welcomes the protection of netting at the level of a CCP's segregated business lines and their associated default waterfall. For the purposes of ensuring the regulatory capital position of direct clearing member participants, provided that the transfer of some but not all amounts due between the CCP and a member and subject to a single netting arrangement is not permitted, which appears to be the aim of this provision, the safeguard is a critical inclusion.

In the Consultation, HM Treasury states: "To ensure collateral and netting arrangements are protected the only possible partial property transfer of a CCP's clearing business that would be possible, under the current proposal, is where a complete segregated business could be transferred." It is understood that the protection provided for in Article 3 of the Draft CCPs Order is intended to allow the authorities to transfer one or more whole business lines – which are viable and solvent – to a third party, leaving the failed or failing business line behind in the residual CCP. A business line may be considered to have failed when the default waterfall has been exhausted without addressing all relevant losses, and to be failing when it has become clear that the default procedures will be unable to proceed successfully (see further response to Question 24 below). ISDA welcomes this as a policy position, but considers that it could be more clearly articulated in the Draft CCPs Order, failing which, and as a (substandard) fallback, it should be clearly articulated in the Code of Practice.

As a related point, it is anticipated that any transfer of CCP business (as opposed to a share transfer), whether for the whole of its business or a part, would be an immensely complex and novel exercise. Whilst we agree with the reservation of PPT powers, subject to appropriate safeguards, it is worth noting that other approaches may be sufficient to achieve the same outcome in a CCP resolution scenario without the same level of legal and practical complexity and it would be helpful if these were acknowledged in any Code of Practice.

Specifically, we understand that CCPs may well design their default fund rules so that upon exhaustion of the default fund waterfall for a segregated product there is limited recourse so that the CCP is not obliged to honour remaining obligations under affected contracts and can therefore remain solvent whilst the particular product line is effectively closed down and subject to mandatory tear-up (indeed, if this were not done, the failure of a particular product could still push the CCP into failure which would then impact other "segregated" default funds, rendering their segregated status ineffective). If such arrangements were effectively implemented, it would potentially remove the need to move untainted business lines out of the CCP because the CCP could continue to operate the business without risk of insolvency caused by the failed business line. This might be a less systemically disruptive solution in such circumstances than using a PPT mechanism to protect the untainted business in a new CCP.

ISDA notes, in relation to the drafting of Article 3(3)(a) of the Draft CCPs Order, that a segregated default fund may apply to more than one class of financial instrument. Article 27.3 of the EMIR Regulatory Technical Standards (as referred to in paragraph 5.5 of the Consultation), requires that "[a]ll financial instruments to which portfolio margining is applied shall be covered by the same default fund"; it does not require that a default fund apply only to a single financial instrument class. Accordingly, it may be appropriate to amend Article 3(3)(a) so as to refer to "class or classes of financial instruments".

We note that various industry developments in clearing already contemplate and rely on the existence of separate netting sets in relation to particular CCP services, as the basis (amongst other things) for delivering EMIR client protections. HM Treasury might find it helpful to review the ISDA / FOA Client Clearing Documentation, available at: http://www.isda.org/publications/isda-clearedswap.aspx, which references the netting sets expected to be established by CCPs. These netting sets will form the basis of legal opinions obtained by the industry and it is therefore important that any approach to identification of segregated business lines for the purposes of potential CCP resolution powers does not undermine such arrangements – the concepts should in principle be aligned.

Question 24 *Do you agree with the proposal to modify article 7?*

Article 7 of the 2009 Order states as follows:

> *"A property transfer order to which this Order applies may not transfer property, rights or liabilities or include provision under the continuity powers to the extent that to do so would have the effect of modifying, modifying the operation of or rendering unenforceable—*
>
> *(a) a market contract;*
>
> *(b) the default rules of a recognised investment exchange or recognised clearing house; or*
>
> *(c) the rules of a recognised investment exchange or recognised clearing house as to the settlement of market contracts not dealt with under its default rules."*

Article 6 (Markets Contracts) of the Draft CCPs Order states as follows:

> *"A partial property transfer to which this Order applies may not transfer property, rights or liabilities or include provision under the continuity powers to the extent that to do so would render unenforceable a market contract."*

In other words, the protection for CCP default or other rules available in the case of a bank resolution will not be available in the case of a CCP resolution.

ISDA understands, but would welcome clarity from HM Treasury, that it is not intended that Article 7 of the 2009 Order itself be amended.

ISDA is of the view that intervention by the authorities using SRR powers prior to a failing CCP's default procedures having manifestly failed, or the point at which it becomes clear that such procedures are unlikely to proceed successfully, could have significant negative consequences for market participants, including end-user clients. This is because "[t]ransparency and certainty for direct and indirect participants is essential as to (i) the nature and operation of the default management process and any default waterfall, (ii) the nature of loss allocation in all circumstances including the exhaustion of the default waterfall, and (iii) the relevant decision makers (i.e., Risk Committee, FMI management, or the resolution authority) at each step of any default management process or recovery and resolution measures."[5] Such transparency feeds in to, inter alia, the

[5] See the joint response of ISDA, the IIF, The Clearing House, GFMA, AFME, SIFMA and ASIFMA dated 15 October 2013 to the FSB consultation document "Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions " and the CPSS-IOSCO Consultative report "Recovery of financial market infrastructures", available at:

http://www.financialstabilityboard.org/publications/c_131024af.pdf

capital requirements of CCP members and the risk assessment procedures of both direct and indirect clearing members. It is noted that the authorities have the particular ability to raise concerns regarding a CCPs default waterfall or other arrangements and that they should raise any such concerns during their review of the FMI's recovery or resolution plan, rather than impose a change during the resolution process itself.

ISDA is of the view that it is essential that clearing members of CCPs have absolute transparency and limited, quantifiable liability. As stated in ISDA's response dated 23 December 2012 to the European Commission's 'Consultation on a possible recovery and resolution framework for financial institutions other than banks':

"Clearing Members (CMs) of CCP's require limited liability to prevent systemic risk. Recovery measures and any resolution regime must provide this in a way which has certainty and transparency. Measures such as recapitalisation, the closure of segments of a CCP and variation margin ("VM") haircutting must be implemented in a way which does not contradict the principle of CM limited liability, and features such as forced tearups and uncapped default fund liability should be avoided altogether."[6]

In this regard, ISDA welcomes the findings of the recent European Parliamentary ECON report on recovery and resolution framework for non-banks, dated 22 October 2013. In calling for a motion for a parliamentary resolution, paragraph 20 of the Report states that the European Parliament "[a]sserts that the dividing-line between recovery and resolution in the case of CCPs is when the default waterfall is exhausted, and the loss absorption capacity of the CCP has been depleted".[7]

On the basis of HM Treasury's comments in the Consultation, as discussed in response to Question 23 above, ISDA understands that the modified Article 7 as proposed to be included as Article 6 of the Draft CCPs Order is not intended to allow the authorities to interfere with the default or other settlement, rules of an RIE or CCP. In particular, because a PPT will only be available in respect of an entire, segregated business line which is not failing, there would appear to be no cause for the authorities to interfere.

In relation to the drafting of Article 6 (Market Contracts) of the Draft CCPs Order, and ISDA's response to Question 14 of this Consultation above, ISDA would welcome consideration by HM Treasury of:

(i) the interaction between the new client protection objective of the resolution regime and the client protection safeguards of EMIR relating to porting or return of client assets upon the default of a clearing member of a CCP (which may precede CCP failure); and

(ii) consideration of the latter EMIR client protection provisions in the application of the resolution regime to CCPs.

ISDA would accordingly ask HM Treasury to consider the extension of the protection it has given to market contracts in Article 6 of the Draft CCPs Order to the arrangements protected by virtue of recent changes to Part VII Companies Act 1989 such as qualifying property transfers, transfers of property made in accordance with Article 48(7) EMIR, etc.

Question 25 *Do you agree with the removal of the safeguard around capital markets arrangements?*

ISDA makes no comment in response to Question 25.

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[6] ISDA's response is available at: http://ec.europa.eu/internal_market/consultations/2012/nonbanks/registered-organisations/international-swaps-and-derivatives-association-isda-_en.pdf.

[7] Available at: http://www.europarl.europa.eu/document/activities/cont/201310/20131023ATT73307/20131023ATT73307EN.pdf.

Question 26 *Do you agree with the removal of the safeguard concerning reverse transfers?*

ISDA agrees that, on the basis of its understanding that a PPT in respect of a CCP will only ever transfer a complete segregated business, it is doubtful that a reverse property transfer order would ever be made with respect to a CCP. However, ISDA disagrees that it is appropriate to remove the relevant safeguard. Rather, if the power to make a reverse property transfer order with respect to a CCP will subsist, then it is important that the safeguard also remain in place. There is otherwise a risk that the original transferor may be transferred additional property, rights or liabilities under a reverse property transfer order and may consequently find itself (and thus its creditors) in a worse position than it would have been in had the original PPT not occurred.

As an alternative, HM Treasury may wish to disapply the power to make a reverse property transfer order with respect to a CCP.

Question 27 *Are there additional safeguards you would expect to be included that have not been considered, and what are they?*

The Consultation states at paragraph 5.6 that "[t]he government proposes to carry across most of the safeguards from the 2009 Order. These are the protections for set-off and netting; secured liabilities; trusts; and termination rights." However, there are no express provisions for protection of set-off arrangements, netting arrangements or title transfer collateral arrangements in the Draft CCP Order. The Draft CCP Order appears to contemplate that such arrangements will be protected under EU law (see Articles 4 and 10). There is at present no such protection for set-off arrangements, netting arrangements or title transfer collateral arrangements in the context of a CCP resolution under EU law. It is critical that set-off arrangements, netting arrangements and title transfer arrangements be protected in the event of a CCP resolution, as much as in a bank or investment firm resolution. See paragraph 2(j) (on pages 4-5) of the joint associations' response to the FSB consultation, as referenced at footnote 5 above. ISDA therefore suggests that Article 3 of the 2009 Order be carried across in to the Draft CCP Order *mutatis mutandis.*

ISDA welcomes the inclusion of clause 7 of the Draft CCPs Order, which will provide protection for clients in the context of many CCP structures. Some CCPs hold assets referable to client positions pursuant to trust structures, under which the CCP or an affiliated company may act as trustee. It is important that any resolution action does not interfere with the rights or property interests of such clients. ISDA understand that Article 7 of the Draft CCPs Order will operate to protect clients in circumstances where the CCP itself is a trustee, and that Article 7a of the 2009 Order (which is in substantially identical terms) will operate to protect clients in circumstances where an affiliate of the CCP is a trustee.

Question 28 *Do you feel any of the proposed safeguards are superfluous and why?*

No. ISDA is of the view that all of the proposed safeguards are necessary and, in addition, considers that the safeguards for set-off arrangements, netting arrangements and title transfer collateral arrangements are also necessary in the context of CCP resolution, as noted in response to Question 27 above.

Question 29 *Do you agree that no changes are required to the NCWO Order?*

ISDA makes no comment in response to Question 29.

Question 30 *Do you have any concerns over the likely effectiveness of the safeguard Regulations as they are presently framed?*

ISDA makes no comment in response to Question 30.

Question 31 *Do you agree that there is no need for a NCWO order to specify the terms to be applied when a clearing house compensation order is made under 89F in the case of PPT?*

In the Consultation, HM Treasury states "It is anticipated that clearing house compensation orders would only be made in exceptional circumstances". While ISDA agrees that there limited circumstances in which a compensation order might be needed, in circumstances where a PPT in respect of a CCP can only be used to transfer a complete segregated business line (as to which see the response to Question 23 above), ISDA submits that such a transfer may involve a transfer of capital which might otherwise be available as part of the default waterfall of the remaining (failed) business line. A transfer of this kind would have the impact of leaving creditors (including both direct and indirect clearing members) worse off than they may have been in an insolvency.

ISDA would welcome further clarification from HM Treasury as to why it considers that an NCWO order is not necessary. Absent such further clarification, ISDA is of the view that where it remains possible that a PPT in respect of a CCP may leave a creditor worse off, provision for the making of a third party compensation order is necessary.

Question 32 *Do you have any specific recommendations for terms that need to be updated for the effective extension of these rules to investment firms? Or banking group companies?*

ISDA makes no comment in response to Question 32.

Question 33 *Do you have any further comments?*

ISDA makes no comment in response to Question 33.

Question 34 *Do CREST clearing members believe there is an increase in perceived risk as a result of the extension of the secured liabilities safeguard with respect to floating charges? If yes and if possible, pleas provide evidence of these effects being observed in relation to deposit takers already in scope of the existing regime.*

ISDA makes no comment in response to Question 34.

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Annex 1

International Swaps and Derivatives Association (ISDA)

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.