BBA, ISDA and FOA response to HMT Segregation and Portability Consultation

1. INTRODUCTION

1.1 The British Banker's Association, the International Swaps and Derivatives Association and the Futures and Options Association ('the signatories') agree with the HMT's approach of seeking to ensure that the EMIR porting requirements are specifically recognised under English insolvency law in order to ensure certainty as to the operation and protection of the porting option on the insolvency of a clearing member.

1.2 Although EMIR has direct applicability in UK law, we think that relying solely on the EMIR provisions will result in significant uncertainty as to the operation and effect of the porting provisions. The proposed amendments should perform two important functions: (i) provide explicit protection from English insolvency law for certain transfers; and (ii) extend the EMIR porting provisions to the back-to-back client trades with clearing members (***client trades***), which arise where the clearing member is acting as principal, and the associated margin held by the clearing member.

1.3 In respect of porting in general, we note that this should not be mandatory but ought to remain subject to agreement between a non-defaulting clearing member (***NDCM***) and the relevant underlying clients. Where feasible, parties should be allowed to agree porting arrangements that extend to both whole and partial porting of clients and positions. We feel that a flexible approach would be beneficial as it would allow market participants to explore whatever solutions are most suitable in the circumstances. Although we envisage that porting arrangements would generally be agreed prior to a clearing member default, we think it would be helpful if porting agreed subsequent to a default could also be protected.

Impact of English insolvency law

1.4 It is doubtful whether the provisions in EMIR would, without more, override provisions of English insolvency law in relation to the transfer of assets and positions which might legally belong to a defaulting clearing member (***DCM***). Where the DCM deals as principal with the CCP[1] then margin and positions at the CCP, even if

[1] References to CCP in this paper are to CCPs authorised under EMIR.

relating to client trades, will technically be the property of the DCM. A transfer of those positions and assets by a provision of a private law contract (such as the membership rules of the CCP) could constitute a void disposition under English insolvency law.

1.5 Consequently, we agree with the basic approach of the HMT consultation which, through the amendments to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (as amended) (the ***Recognition Requirements***) and Part VII of the Companies Act 1989 (***Part VII***) aims to provide a mechanism to transfer both assets and positions at the CCP, as well as corresponding margin and client trades with the DCM, in a way which should protect those transfers under English insolvency law.

1.6 Of course, the protection of Part VII will only apply in relation to a DCM which is subject to English insolvency law and the Recognition Requirements will only apply where the CCP is subject to English law. The position is less clear where either the clearing member or the CCP is located in another jurisdiction. The effect of the proposed amendments to legislation, together with EMIR, in such circumstances would need to be further explored. However, it would appear that transfers of assets and positions belonging to a non-UK DCM would not be protected if the insolvency law of the clearing member's jurisdiction of incorporation or establishment did not provide an equivalent level of protection from the applicable insolvency law. At least, the overriding nature of the EMIR provisions could be unclear in those circumstances.

1.7 As such, transfers by the CCP pursuant to its default rules might be subject to challenge under the insolvency law applicable to the non-UK clearing member. A requirement imposed at EU level on member states to protect the porting of assets and positions (both at the CCP level and the level of the clearing member) from the effects of member state insolvency law should be considered.

1.8 Portability rules should also be consistent with Recovery & Resolution regimes.

Transfer of client trades with the DCM and associated margin

1.9 Article 48(5) and 48(6), which deal with porting, require the CCP to "contractually commit" to trigger a transfer to an NDCM where the clients of the DCM request the transfer and have in place a contractual arrangement with an NDCM which commits the NDCM to accept a transfer. In practice, it would make sense for the DCM to also be party to these arrangements.

1.10 The "contractual commitment" referred to is likely to comprise a provision of the CCP's rules (and/or clearing member agreement) which provides for a transfer of assets (i.e. margin) and positions in financial instruments. However, this transfer can only affect the assets and positions held at the CCP: Article 48(5) and 48(6) refer back to assets and positions held in accounts in accordance with Article 39(2) and 39(3), which are accounts at the CCP.

1.11 Consequently, the basic provisions of EMIR only envisage porting of the margin and positions held in accounts at the CCP. They do not provide for the transfer of any margin (or indeed back-to-back client trades) held by the DCM for its underlying clients.

1.12 Without the ability to transfer excess margin held with the DCM there is a risk that an NDCM will not agree to accept transfers of client positions. Although client positions of the DCM may be recorded on a net basis at the CCP, the DCM's exposure to its clients will be on a gross basis since the DCM cannot net the positions of different clients on its books and records. The position becomes even more complex in the case of cross-margining, as explained below.

1.13 Trades between the clearing member and its clients will therefore need to be margined on a client by client basis by the clearing member. If the NDCM accepts a transfer of client positions at the CCP it will only receive the net margin associated with those positions at the CCP. In order to cover its gross exposure to the transferring clients, it is also likely to want to receive the excess gross margin held by the DCM.

1.14 If the excess gross margin held by the DCM cannot be transferred then the alternative would be for the NDCM to require transferring clients of the DCM to post additional margin as a condition of it accepting the transfer. Transferring clients would then have to recover the excess gross margin originally posted with the DCM from the DCM.

2. PROVISIONS FOR TRANSFER IN THE RECOGNITION REQUIREMENTS

2.1 As a general observation, there is no explicit requirement in the amendments to the Recognition Requirements for CCPs to have default rules which provide for the transfer of client positions and associated margin at the CCP, nor the transfer of client trades and associated margin from a DCM to an NDCM. The amendments to the Recognition Requirements make certain provisions in relation to such transfers (for example, the requirement in paragraph 5(1)(c) that no transfer can take place without client consent), but there is no explicit provision which requires a CCP to include in its default rules the power to make such a transfer.

2.2 In relation to the transfer of client positions and associated margin registered with the CCP this may not matter as the provisions of EMIR will be directly applicable (although we think it may be helpful to include express provision or reference in the Recognition Requirements). However, as stated above, EMIR does not provide for the transfer of the client trades between the DCM and its clients and any associated excess margin held by the DCM. We think that the Recognition Requirements should expressly require the default rules of a CCP to include provisions that would enable it to require the transfer of client trades and associated excess gross margin from a DCM to an NDCM where the corresponding client positions and margin at the CCP are being transferred and, in respect of the excess gross margin, the parties have agreed that this should also be ported. In practice, this will be likely to require multilateral agreements between the CCP, DCM, NDCM and each of its clients to enable the novation of client positions and client trades, and the transfers of margin, from the DCM to the NDCM.

3. TRANSFERS OF CLIENT POSITIONS AND MARGIN AT THE CCP

3.1 The proposals provide for protection from English insolvency law for the transfer of client positions held at the CCP and associated margin (provided under a qualifying collateral arrangement). While we agree with the general approach of the proposals, we think there are likely to be some practical implications for their application.

3.2 The proposals will protect the transfer from a DCM to an NDCM of client positions registered to an omnibus client account at the CCP. Where the DCM is acting as principal it is possible that this account may record the net position across all client positions of the DCM, although general market practice is currently not to net client. Margin supporting such client positions may also be provided to the CCP on a net basis.

3.3 According to paragraph 5(1)(c) of the Recognition Requirements, no transfer of any client position at the CCP or "qualifying collateral arrangement" (i.e. associated margin) at the CCP can take place before the client which is a party to the client trade requests its transfer. Paragraph 5(2) then provides that where the client's positions are registered to a client omnibus account, paragraph 5(1)(c) does not prevent the CCP's default rules from providing for transfer of the positions and margin of one client within the group of clients whose positions and margin are registered to the omnibus account to an NDCM.

3.4 If some, but not all, clients' positions and associated margin are transferred then this will impact the net position of the account at the CCP. For example, if client A and client B have offsetting positions then at the CCP these offsetting positions will reduce the margin required (and, depending on how the CCP records the positions, it is possible that only the net position may be recorded). If client A requests the transfer of its positions on a default of its clearing member, but client B does not, then the offset will be lost and the position in the NDCM account will not be the same as that in the DCM account. Without the offset there may be insufficient margin available to be transferred with the position, with the result that the NDCM may require client B to provide additional margin as a condition of accepting the transfer.

3.5 Even if all of the DCM's clients' positions and associated margin is transferred, the transfer of these positions to the NDCM may alter the NDCM's net client position with the CCP. If the DCM's client positions are transferred into the NDCM's omnibus client account then this could create a new net position with the CCP for the NDCM which may require the provision of additional margin (or trigger the return of margin). For this reason it would be sensible to transfer the positions and connected margin to a separate client omnibus account with the CCP held for the account of the NDCM's ported clients.

3.6 We think there will need to be an ability to make a partial transfer of clients' positions and margin. Even if all clients of a DCM with positions and margin in a client omnibus account wish to transfer it is quite possible that they will have contractual arrangements with different NDCMs, which will require several partial transfers to the different NDCMs from the omnibus account.

3.7 It should also be considered whether margin held at the CCP level in circumstances where the underlying client has not yet provided the margin to the DCM (e.g. because of a timing difference between the DCM providing the margin to the CCP and calling from the margin from its client) should form part of the margin that is transferred to the NDCM or whether it should be returned to the DCM for its own account. The treatment of this margin may depend on the contractual arrangements between the DCM and the client (e.g. it may be considered as a temporary loan to the client). If the full amount of margin is ported in such circumstances then the DCM (or its administrator) would be left to claim the outstanding margin from its client, whilst the client would, in the meantime, receive the benefit of margin that it has not provided. On the other hand, if this part of the margin is returned to the DCM then a shortfall of margin is likely to arise at the CCP level, which may cause difficulties in relation to the porting (as further described below). Porting may also be more difficult in such circumstances since a calculation would first have to be made as to whether the underlying client has transferred sufficient margin to the DCM (and the amount of the shortfall, if any) before any margin at the CCP level can be ported. When determining the correct approach to such circumstances, both the burden and benefit of calculating the exact amount of margin to be ported as against what the underlying client has provided would have to be taken into account (and also recognising the benefits to the DCM as a result) and weighed against the convenience of porting the entire amount (whilst leaving the DCM to claim for any outstanding margin from its clients).

4. TRANSFERS OF CLIENTS' MARGIN HELD WITH THE DCM

4.1 While we consider that protection for the transfer of margin held with a clearing member, as opposed merely to margin held with the CCP, could be important in making porting attractive to a recipient NDCM there are a number of legal and practical issues which may restrict the circumstances in which such margin can, in fact, be transferred.

Cross-margining arrangements

4.2 If a DCM permits cross margining (or a margin offset) between products, some of which may not be cleared with the relevant CCP and therefore subject to porting, then the DCM will not necessarily hold sufficient excess margin in a form that can be transferred to the NDCM. For example, a client of a prime broker may be given margin credit for securities that have been borrowed by the prime broker. If the prime broker is also the client's clearing member then on a default of the prime broker there may not be an amount of margin in the form of cash or liquid securities being held by the prime broker for the client which can readily be identified and transferred to the NDCM. Another example is where the client of the DCM has been trading the same stock across different exchanges (e.g. buy on exchange A, sell on exchange B), which are subsequently cleared by different CCPs. The DCM may opt to margin its clients on a net position basis, while being margined itself by the two CCPs on a gross basis (i.e. separately on the basis of each trade).

Security

4.3 Similarly assets which are held by the DCM as margin provided by the client in respect of the client trades may be subject to a security interest or right of set-off which secures not just the client's obligations under the cleared trades at a particular CCP but also the client's obligations in relation to trades on other CCPs, obligations in relation to other financial instruments and in relation to other liabilities to the DCM and potentially also liabilities to other companies in the DCM's group.

4.4 The requirement in the draft amendments to Part VII excludes collateral arrangements which do not provide cover "solely" for exposures arising out of the client positions with the CCP or the related client trades between the client and the DCM. In practice, we think this restriction may limit the ability to port excess margin held by a DCM.

4.5 Margin received by a clearing member which is not required to be transferred to a specific CCP may be held in a general account for the client on the books and records of the clearing member. It may be subject to a general form of security or right of set-off (if margin is provided by title transfer) in relation to all the client's liabilities to the clearing member. Even if the client trades only cleared products, the margin held by the clearing member will not necessarily be "solely" in relation to a particular client trade but may provide general security for all the client's trading positions with the clearing member[2].

4.6 It therefore needs to be clear whether the margin held by the DCM is only covering the open positions of that client towards that CCP, or whether it also covers other obligations. In the latter case, porting that margin may be impossible.

Application of requirements to third parties

4.7 In order to ensure that margin can effectively be transferred it may be necessary to provide additional legislative measures which would be binding on third parties that may be holding the margin for the DCM, such as a third party bank, custodian or an (international) central securities depository (***(I)CSD***).

4.8 The current approach of the HMT proposals is to impose a requirement under the Recognition Requirements Regulations on a CCP to have as part of its default rules provisions which will facilitate the transfer of margin which forms part of a qualifying collateral arrangement between the client and the DCM. These provisions in the clearing house rules can bind the DCM but they will not bind any third party, such as a bank, custodian or (I)CSD, which is holding cash or other assets forming part of a qualifying collateral arrangement. Consequently, there may be a practical difficulty in giving effect to the transfer if a relevant third party not prepared to make the transfer from the DCM's accounts to a transferee NDCM.

5. SPECIFIC QUESTIONS

1. Does our approach to defining market contracts work? What are the implications for daylight risk of defining market contracts by reference to positions recorded in the accounts of the CCP?

[2] Some aspect of this may be addressed in the drafting of the amendments to Part VII. For example, it could be made clear that the reference in 155(1A)(i) to "solely" for exposures arising out of that client trade does not prevent a financial collateral arrangement which provides security for that and other client trades provided the collateral exclusively covers the client trades which are being ported.

Market contracts

5.1 Overall we think the approach to the definition of "clearing member client contract" and "client trade" works.

5.2 We agree that it is helpful for the 'market contracts' definition to take as a starting point the positions recorded in the records and accounts of the CCP as being held for the account of a clearing member (i.e. proprietary positions) or a for the account of a client of a clearing member.

5.3 We note and agree that the definition of a 'clearing member client contract' would need to include both omnibus client accounts and individual client segregated accounts in order to ensure the proper operation of both Article 49(5) of EMIR in relation to omnibus client accounts and Article 49(6) of EMIR in relation to individual client segregated accounts in the event of the insolvency of a clearing member subject to insolvency proceedings under English law. We further agree that 'client member client contracts' should include both principal and agent positions to ensure flexibility in the way that clearing members operate and CCPs (although UK markets currently operate according to the principal-to-principal model).

5.4 Moreover, we are of the opinion that in respect of principal-to-principal relationships, the porting of the connected underlying client trades (the 'client trade') should also be recognised under English law. Although EMIR does not provide for the porting of these underlying client trades, the NDCM to whom positions with the CCP are ported would need to take on these contracts in order to enable it to account for the positions with the CCP as corresponding with positions entered into between the DCM and its individual clients.

5.5 We would suggest that the actual porting of the underlying client trades is left to be determined in the contractual relationship between the underlying clients, the DCM and the NDCM to whom the trades will be transferred, but that the transfer is then recognised as effective under the insolvency legislation. However, in order to support this we think that the Recognition Requirements should expressly require the default rules of a CCP to include provisions that would enable it to require the transfer of client trades from a DCM to an NDCM where the corresponding client positions at the CCP are being transferred.

5.6 The explanation of the connection between a client trade and a clearing member client account in section 155(1A)(h) of the CA 1989 may need to be clarified to reflect the fact that it is the client trades that give rise to the clearing member client contracts, not the other way around.

5.7 Arrangements will also need to be in place to ensure that settlements (at the (I)CSD) related to transferred positions are simultaneously cancelled and rerouted to the NDCM (or its settlement agent) as required. (In this respect, it is to be noted that clearing members often act as settlement agent for their clearing clients, and incur settlement exposure as a result. The margin is often covering the mark-to-market risk on those settlement positions as well, requiring simultaneous cancellation and rerouting.)

5.8 Given that the objective is to provide protection to clients of a clearing member upon the insolvency of the clearing member, we agree that the clearing member's own proprietary positions should not be included within the porting regime and that these should be liquidated pursuant to the CCP's default procedures (in accordance with the position under Article 48(4) of EMIR).

Daylight risk

5.9 In most markets, the daylight risk in respect of positions is limited as there is usually very little time between the moment of execution of a trade on the exchange or other trading venue and the entering into of the equivalent trade with (or the novation of the trade to) the CCP. It is, however, possible that technical issues could prevent immediate novation to the CCP.

5.10 On certain F&O exchanges there will be contract formation before novation to the CCP takes place, but it will generally be the case that under exchange rules the exchange can cancel or adjust such trades in the event that one of the parties becomes insolvent before the trades are taken up by the CCP. Additionally, up to the point of clearing, such trades will not be margined. As such, we do not consider it necessary to expand the definition of market contract to include the temporary stage of trade formation between counterparties across an exchange but before clearing.

5.11 Rather than daylight risk being an issue of particular concern for positions, it mainly arises in respect of margining, i.e. it relates to the fact that the margin held at the CCP will almost never exactly correspond with the open trades at the CCP. This could be as a result of new trades having been executed or old trades having been settled in the period between margin calls. The result is that it may be unclear which margin relates to particular positions. Additionally, the clearing member usually pays or is debited the margin by the CCP before margin is paid by the client to the clearing member.

2. Is it necessary to include a reference to a "group of other such contracts" in the definition of client trade? In other words, can we always assume that there will be a one-to-one correspondence between a client trade and a CCP?

5.12 Clearing members would generally not net or offset positions across clients, so there would always be a one-to-one correspondence between a client trade and the position at the CCP. As such, we do not believe the reference to a 'group of such contracts' is required. (The one-to-one position may, however, not extend to margin, which may be calculated by the CCP on the basis of the aggregate positions in an omnibus account, i.e. the CCP margin call toward the clearing member could be reduced due to offsetting trades between different clients of the clearing member.)

3. Does our approach work for the agency model of clearing?

5.13 UK and European clearing houses and clearing members generally apply the principal-to-principal model for clearing. However, given developments in the market it would be helpful for the legislation to be sufficiently flexible to accommodate future initiatives which may use an agency model.

4. Would there be circumstances in which porting as contemplated should not take place?

5.14 We do not think that there are necessarily any specific circumstances in which porting as contemplated should not take place, however there may some circumstances where porting would not be appropriate. We have suggested below that in some circumstances it may be appropriate to port excess gross margin. However, whether this is possible may depend on how that margin is provided (i.e. pursuant to a security interest or title transfer arrangement), whether the appropriate margin can be identified as well as the contractual arrangements between the parties. This is discussed further below.

5.15 Where there is insufficient margin at the CCP, porting could also be inappropriate and the positions may have to be liquidated instead with the cash going back to the administrators of the DCM. However, it is possible that other arrangements could be put in place to provide for such circumstances. This is also discussed further below.

5.16 Although Article 48(5) and 48(6) of EMIR require the CCP to commit to transfer positions and associated margin, this is dependent on there being a request from the DCM's clients to do so and also a pre-existing commitment from an NDCM to accept those positions. We think it will be important that the NDCM's commitment can be conditional so that it is not required to accept a transfer in all circumstances (for example, the NDCM's own financial position may be such that it cannot safely accept a transfer of the DCM's clients' positions, or where the NDCM requires additional margin).

5. Would there be circumstances in which porting beyond what is contemplated should take place?

5.17 It is necessary to cite the distinction between between "gross omnibus" accounts - defined as accounts for which the clearing member is required to post at least the sum of the margin amounts as calculated under the CCP methodology for each client portfolio separately - and "net omnibus" accounts, defined as accounts which allow the clearing member to post less than this aggregate amount. Porting, and also partial porting, of assets and positions in gross omnibus accounts appears economically achievable. For net omnibus account structures, porting the entire portfolio of assets and positions as a unit would be very difficult and rarely work in practice. Partial porting out of net omnibus accounts may not be economically feasible. By definition, after porting sufficient collateral to cover the margin required for a subset of positions, the remaining positions in a net omnibus account will typically and consistently be under-margined. The situation that "excess margin could arise in respect of the remaining positions", as stated at the top of page 10 in the draft document, will "almost surely" not arise. Similar, but even more complicated, problems for porting arise in interoperability arrangements between CCPs - purely because of how margin amounts are calculated and irrespective of legal challenges.

Partial porting

5.18 We believe that partial porting of positions contained in an omnibus account should also be clearly recognised under English insolvency law (e.g. porting of only some of the positions contained in an omnibus account where not all clients wish to be ported to the same NDCM or where the NDCM does not wish to take on all the omnibus clients). The Part VII protections, as drafted, seem to apply only to the transfer of the entire clearing member client account. However, paragraph 5(2) of the Recognition Requirements appears to provide for the ability to move the assets and positions of one client from within a group of clients in an omnibus account.

5.19 Although EMIR does not provide for partial porting, it seems that there is nothing to prevent a clearing member and underlying clients from coming to such an agreement. However, for the arrangements to be effective where a clearing member goes insolvent, it would be important to provide for adequate protections under English law. This is particularly important as EMIR does not provide for partial porting and the 'Regulation override' would therefore not apply.

5.20 As UK markets are generally based on one-to-one arrangements in respect of positions with the CCP and the underlying clients, there should not be a problem with separating out the positions relating to one client from those relating to one or more other clients. However, we recognise that there may of course be other practical and legal challenges connected with partial porting.

5.21 In particular, except where the same margin that has provided by the underlying client has been passed on to the CCP on a gross basis, the task of separating out the margin corresponding with one position from that corresponding with another, and ensuring that there is sufficient margin to cover both ported and remaining positions, would pose a challenge for the following reasons:

- A CCP will generally call for margin on the basis of the aggregate positions in an omnibus account, with the different trades being offset against each other. As well as making it difficult to determine which margin relates to which trades (as the margin provided secures all the positions in the account), this also means that if only some positions were transferred to another account with a NDCM together with sufficient margin to cover those positions, a shortfall or excess of margin could arise in respect of the remaining positions in the omnibus account (as the offsetting of the positions would now be different). In those circumstances, partial porting would only be feasible where there would be sufficient margin to cover both the ported and the remaining positions and a process was in place (possibly in the CCP's default procedures) to determine how margin would be allocated between the positions. Other solutions to deal with a shortfall could potentially be found in an ability to call for further margin by the NDCM or a transfer of gross excess margin from the DCM to the NDCM. Please see question 6 below for further discussion of these options.

- A clearing member will often call for margin from a client after it has provided the required margin to the CCP. Additionally, whilst clearing members may provide margin on a net basis to the CCP (netted across all positions in the net omnibus account), the clearing member may call for margin on a gross basis from its clients. The margin calls to clients can also be in respect of a number of different obligations, of which the margin requirement relating to the trades with the CCP is only one. The margin at the CCP level will therefore often be of a different type from that provided by the underlying client. There may also be other reasons why a clearing member would choose to satisfy its obligation to provide margin to the CCP in respect of client positions with a different type of margin from that provided by the client. This also makes it difficult to determine which margin is intended to correspond with which trades.

- Allocating specific margin to specific positions being ported is complicated by the fact that the margin lags behind the positions (e.g. margin may only be called once a day, whereas the open positions could be constantly changing with settlements occurring throughout the day). The margin at the CCP will therefore rarely correspond with the open trades at the CCP.

5.22 The industry would need to consider in detail whether CCPs, clearing members and underlying clients could determine in contractual arrangements between them, supported by the CCP's default procedures how margin would be divided up and allocated in the event of a partial porting. Potential shortfalls in margin would also need to be considered, although solutions similar to those mentioned in respect of question 6 below may be possible.

Indirect clearing

5.23 HMT will be aware of the ongoing discussions that the industry, through ISDA, is having with ESMA as to how clearing members can implement indirect clearing arrangements satisfactory to, and in line with the draft RTS issued by, ESMA. Please see the industry response to the Consultation Paper issued by ISDA/BBA/AFME/Associm to ESMA on 5 August 2012, which highlights the need for a suitable regulatory framework in each jurisdiction to support the requirement on clearing members to facilitate alternative 'omnibus' and 'individual segregated' levels of protection for indirect clients and also the facility of porting, in line with EMIR (the response can be found at the following link: http://www2.isda.org/functional-areas/public-policy/europe/). We therefore believe that the HMT proposal should consider how this can be accommodated within the changes to Part VII and the Recognition Requirements, as the RTS further develops and takes shape.

6. Do you consider that we should facilitate transfers between clearing members of a net omnibus account in circumstances where the "gross-net" amount of assets would be provided by clients? If so, how would it work?

5.24 We consider that the porting of net margin should be provided for in respect of net omnibus accounts (i.e. where the positions of the various clients participating in the omnibus account are netted against each other and net margin is posted to the CCP). Whether the gross excess provided to the DCM should also ported may depend on the circumstances, as further explained below.

5.25 As partial porting has been discussed under question 5 above, we have primarily considered porting of the entire net omnibus account in this section.

5.26 There is of course a risk that, given the time lag between the open positions recorded in the account and the margin being called, the account will either be over- or under-collateralised. We note that this is not a concern that relates specifically to net omnibus accounts, but to all accounts at CCP level. Under-collateralisation may also occur as a result of causes other than a timing difference, e.g. the default of one underlying client to provide margin may cause the default of a clearing member and this may again result in the CCP using some of the initial margin to cover the shortfall. Less initial margin will then be left to be ported to another clearing member. In that scenario, one underlying client may cause a loss that would impact on the other clients with positions in the same omnibus account.

5.27 Where an account is over-collateralised, then concerns in respect of the porting of net margin should not arise. Provided contractual relationships are in place between underlying clients and the NDCM to whom the positions are ported, the return of excess margin could be dealt with between those parties.

5.28 However, where the account is under-collateralised, then the NDCM to whom the positions are ported would be required to provide further margin to the CCP at the next margin call. It is possible that concerns around under-collateralisation could be dealt with in the contractual arrangements around porting and/or by adapting market practices to suit the circumstances. We have considered some possible options for dealing with this below:

- The NDCM could agree to take on the positions in the account only if there is sufficient margin in the account, which could also be transferred. That would of course limit the circumstances in which porting would be available.

- The contractual porting arrangements could provide for the NDCM's ability to call for the margin shortfall from the underlying clients immediately upon porting. The NDCM would, however, be exposed to credit risk on the clients until that margin has been provided. Whether the NDCM is willing to take that risk will depend on the identity of the clients and their relationship with the NDCM. The ability to provide for partial porting may be relevant to this, as it is possible that an NDCM would only be willing to take on some of the clients forming part of the relevant omnibus account. Another potential solution would be to structure the omnibus accounts according to previously agreed porting arrangements, so that, for example, all clients that have a porting arrangement with 'CM X' (and that CM X is willing to take the credit risk on) in the event of 'CM Y's' default would have their positions and margin recorded in one client omnibus account for 'CM Y', which is kept separate from positions and margin relating to CM Y's other clients. The positions and margin would then be ready for porting to CM X, if required, and the appropriate contractual framework would be in place allowing CM X to call for any margin shortfall from the relevant clients immediately.

- A further possibility would be to provide for the porting of any excess gross margin held by the clearing member in respect of the positions in the relevant omnibus net account (or the segregated account). However, if the clearing member employs a different margining methodology to the CCP, or employs portfolio margining, a 1-to-1 reconciliation of margin held at the DCM level with positions at the CCP may not be possible. On the other hand, where the clearing member calculates margin requirements on a CCP by CCP (or obligation by obligation) basis and keeps an internal record allocating the margin per CCP, the position would be clear. A disadvantage to such margining is that it does not allow for a client's various positions and obligations to be netted off against each other, with the result that the client may need to provide more margin than it would otherwise have been required to. As well as the additional costs for clients, such arrangements would be likely to entail substantial operational changes for clearing members in respect of some business lines. Whether the gross margin has been provided by way of title transfer or security interest (and whether a security interest attaches to the client's right to return of equivalent assets) is also relevant to the question of whether such margin can be transferred, as further discussed under question 6 below.

5.29 We do not intend the above to represent an exhaustive list of solutions or to suggest that any specific requirements should be put on clearing members in respect of how the clearing business is structured as a result. However, we do hope that this gets across that different circumstances and market practices may require different solutions. A flexible legal framework that allows the industry and market participants the freedom to work out what porting arrangements best fit their requirements, and that provides the appropriate protections for such arrangements in the event of an insolvency, would therefore be essential to making porting work.

5.30 We note that the NDCM is likely to also require the excess gross margin held with the DCM in order to cover its gross exposure to each of the underlying clients. Where the transfer of such excess is not possible due to concerns relating to identification of margin or a security interest over the assets (see question 7 below), then the NDCM may require the posting of additional margin by the underlying clients as a condition to taking on the positions. The underlying clients would then have to recover the excess margin originally posted with the DCM from that DCM as part of the insolvency proceedings.

7. Do you envisage that porting might require other transfers of assets between the parties subject to the transfers which might require protection under, or reference in, Part 7?

5.31 We have considered whether the underlying clients' contractual entitlement to the return of equivalent assets in the event of title transfer collateral would also be transferred to the NDCM. It seems that the "qualifying financial collateral arrangement" for these purposes would have to involve the transfer of both the obligation and sufficient equivalent assets (or cash). Otherwise there has been a transfer of an obligation to a clearing member, but no equivalent asset will have been transferred. However, concerns may arise in circumstances where different margin to that provided by the client has been transferred to the CCP and where equivalent gross excess margin is not ported to the NDCM. In such circumstances, porting may be difficult as an NDCM may be unwilling to take on the redelivery obligation without also receiving equivalent assets enabling it to discharge it. Alternatively, the redelivery obligation could be converted to an obligation on the NDCM to deliver assets equivalent to those that have been ported to the NDCM (i.e. the assets held with the CCP as margin and that have been ported to the NDCM, as well as any ported excess gross margin). In circumstances where the redelivery obligation is transferred to the NDCM, then the client's redelivery right as against the DCM should be extinguished. We consider that whether the NDCM and the client will agree to porting in such circumstances, and (if so) on what terms, should be a point for the contractual arrangements between the parties. However, the arrangements and any associated extinguishing of rights would need to be provided for under English insolvency law.

5.32 We note that where a security interest has been granted in favour of the DCM over all the client's rights, title and assets, which covers the client's right to return of equivalent collateral in respect of a title transfer collateral arrangement and which secures liabilities other than those attributable to the positions to be ported, then this may prevent the transfer of the excess gross margin. The amendments to Part VII protect qualifying financial collateral arrangements which are connected to a clearing member client account or client trades, which means they must provide cover "solely" for exposures arising out of that clearing member client account or client trade. If the security over the redelivery obligation secures a broader range of client liabilities then it does not seem that it would be "connected" for these purposes and it would therefore not be protected by Part VII.

5.33 In the event that the client has transferred margin to the DCM pursuant to a security interest, then the security interest and the client's proprietary interest in those assets would also need to be considered. We note that paragraph 6(2)(c) of the amended Recognition Requirements envisage that such property will simply be returned to the client by the DCM. Presumably the rationale is that the client gets their assets back from the security and is then free to post them as margin with the NDCM to whom its positions are transferred. However, if the DCM is in insolvency proceedings, it may take some time for the client to get its assets back. We would therefore query whether the security interest could also be transferred where a gross margin excess is ported to the NDCM in such circumstances (to the extent of the transferred assets), whilst the proprietary right would remain with the client. This would need to be provided in the contractual relationship between the DCM, the NDCM and the client and be subject to appropriate protections in the legislation. However, if the margin secures obligations other than those relating to the positions with the CCP, then we cannot see how those assets or the security interest could be transferred to the NDCM.

8. Are we correct to take the view that section 187 is no longer required for CCPs

5.34 This section relates to market contracts being entered into by parties in different capacities and clarifies that where a person enters into market contracts in more than one capacity, the provisions apply as if the contracts entered into in each different capacity were entered into by different persons. We understand that HMT considers this irrelevant for market contracts between CCPs, CMs and underlying clients; presumably because a specific reference to contracts being entered into as agent or principal is made in respect of a 'clearing member client contract' and the definition of 'client trade' is only relevant where the clearing member is acting as principal.

9. Does our approach make sufficient provision for interoperability arrangements?

5.35 When considering the CCP and contractual arrangements for porting, and the recognition of such porting arrangements under English law, we should also take into account possible interoperability arrangements that may be in place between CCPs (i.e. where two CCPs are involved in the same trade, with each CCP representing a different party to the trade and clearing one leg of the transaction).

5.36 Pursuant to such arrangements, CCPs may call for margin from each other on the basis of all the positions subject to the interoperability arrangements between them, with individual positions having been offset against each other. CCPs will request any such margin required from the clearing members who may (or may not) in turn call for the margin from their underlying clients. One key question seems to be whether such interoperable margin should form part of the insolvent estate of the clearing member on a clearing member default or whether it should form part of the assets that are ported to the NDCM.

5.37 If interoperable margin has been provided by an underlying client the logical conclusion may be that it should be ported together with that client's other positions and assets in order to avoid a situation where the client would have to claim for this separately in the insolvency proceeding of the DCM. However, due to the way in which the margin is calculated by CCPs and provided by clearing members it is likely to be difficult to identify which margin relates to particular clients or positions. Timing discrepancies and issues relating to different margin being provided by the clearing member from that provided by the underlying client may also be relevant here. A further complicating factor is that interoperable margin may be called for and provided by a CCP in respect of both proprietary clearing member positions and client positions.

5.38 In light of the above and the increasing importance of interoperability in the markets, we believe that this is an area that would require further consideration.

11. Is it correct that the SFRs will not require amendment?

5.39 We question whether HMT's conclusion that "It may therefore be the case that the amendments to Part 7 and the Recognition Requirements Regulations will be sufficient to avoid amendment of the SFRs" is supported by evidence, and would welcome HMT sharing with industry how it reached this conclusion. In particular, HMT's assertion that "the SFRs protect the default arrangements of the systems operator (the CCP)", seems misplaced, since industry considers that SFRs are also intended to protect the system participants (in this case the clearing members). We would welcome more clarity from HMT on how it reached this position.

12. What are the financial costs, if any, that you envisage incurring as a result of these changes?

5.40 Although the insolvency law amendments themselves would not impose costs on the industry, we note that any proposals that would require individual account segregation or the keeping of smaller client money/asset pools (e.g. per CCP level) would be hugely expensive to the industry and clients of clearing members.

5.41 As well as being operationally expensive for clearing members (and CCPs) to implement, multiple pool/individual segregation structures would be costly for the industry as a whole (including in respect of additional costs to clients if the ability to net and offset margin is removed) and may have the unintended effect of pricing out or reducing access for smaller clients who may not be able to afford executing or retaining derivative positions as a result.