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### **Response to second HMT informal consultation on indirect clearing arrangements**

We welcome the second HMT informal consultation on indirect clearing arrangements of 2 May 2013 and the intent to provide, so far as is possible, a protective framework for EMIR compliant indirect clearing constructs in the UK. We are grateful for the opportunity to meet with you and discuss these matters further.

At the outset, we consider it is a positive development that HMT proposes to allow for flexibility as between principal and agency models. It is also welcomed that the idea has been dropped that Clearing Members (“CMs”) would themselves require default procedures which would be approved by regulators (and more importantly subject those CMs to powers of direction in the hands of the regulators) for the reasons discussed in our earlier meeting.

We would also like to emphasise the following points:

In relation to liquidation issues, we are keen to avoid any suggestion or requirement that there will always be a “direct pass through up the chain to the CCP” for all client collateral on the basis that key features of a clearing brokerage service (e.g. pre-funding, collateral transformation and financing services), as well as the possibility of net omnibus account structures, would be inconsistent with such a stringent requirement.

It is important that, so far as is possible, actions taken by CMs with a view to facilitating the porting of indirect client positions or returning assets for the account of indirect clients on a liquidation are protected so that the CMs are not themselves exposed to challenge. Equally, it is important to distinguish between the protection/porting/return of (i) positions and assets recorded on the books of the CCP and (ii) positions and assets recorded on the books of the CM. The position in respect of collateral in particular may well be different and Part VII should look, where possible, to protect transfers of each on a client default.

Page 3 of the second HMT consultation, under ‘Default procedures for CMs’, refers to “a CM finding an alternative client” for indirect clients in the event that the indirect clearer has defaulted. We assume this is provided as an illustration rather than being envisaged as a requirement. Please confirm our understanding that CM role here is reactive rather than proactive (except where the CM is willing to agree otherwise as a commercial matter), since its relationship is likely to be with the client rather than the indirect clients.

## HMT Questions

1. *Do you envisage CCPs will have rules providing for the transfer or settlement of positions held for the account of indirect clients if the client providing the indirect clearing service defaults? If so how would they work? And should they be regulated by means of further requirements to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001?*

We agree that the CCP will play a key role in the transfers of positions and assets in accounts with the CCPs and for payments out of those accounts. There are three different default scenarios that would need to be considered in respect of indirect clearing:

*(i) CM default*

This would be addressed under the CCP's default procedures required under Art 48 of EMIR. Recital 6 of the EMIR technical standards further provides that indirect clients should be included in the transfer of client positions to an alternative CM, pursuant to the portability requirements under Arts 39 and 48 of EMIR, in the event of a CM default.

We consider that it would be up to the relevant client providing the indirect clearing service and the indirect clients to agree the relevant porting arrangements between them, together with any back-up client or CM. The CCP will need to seek its instructions from the client in respect of both the client's own and its indirect clients' positions and assets. We do not think these arrangements would require anything further to be done by CMs (other than, potentially, the back-up CM confirming it will take the positions).

*(ii) Client (i.e. indirect clearer) default*

This scenario is not considered under the CCP default procedure provisions of Art 48 of EMIR (which only deal with CM default), but is addressed in the EMIR technical standards. It is this scenario that is of primary concern to HMT's consultation.

We note that although the technical standards focus primarily on the role of the CM, it is clear that in practice CCPs will play a key role in the actual transfer of any positions and assets that are recorded at the CCP level.

However, given the indirect clearing relationship, the CCP will need to take instructions from the CM in the event of a client default.

We agree that the role of the CM in managing the default of a client pursuant to Art 4(4) of the technical standards will be limited to acting in accordance with requests from affected indirect clients, so far as the same are consistent with the CM's contractual obligations assumed as part of its indirect clearing service and do not expose the CM itself to increased risk. . The CM will itself need to receive information from the client or indirect client in relation to what back-up arrangements are in place and will take a 'reactive', rather than a 'proactive', role in seeking to effect those arrangements (i.e. it will not be obliged to search for or find a back-up client or clearing member for the indirect client, unless otherwise specifically agreed as a commercial matter).

We agree that the relevant procedures to effect the actual transfers at CCP level would be those of the CCP. However, we would query whether HMT intends the protections outlined in Part VII of the Companies Act 1989 (*Part VII*) to be strictly limited to circumstances where the CCP's 'default rules' specifically address client default or whether the protections should also extend to circumstances where the CCP's other rules and procedures more broadly enable the CCP to effect the relevant transfers (which seems more appropriate).

In connection with this, we note that the following protections in Part VII are among those that are currently drafted as dependent on actions having been taken pursuant to the CCP's default rules:

- (i) section 159(1), which provides that transfers will not be regarded as invalid at law;
- (ii) section 159(2), which ensures that the powers of a relevant office-holder do not prevent or interfere with transfers;
- (iii) section 164, which provides an exemption from the power to disclaim property, order rescissions, avoid property dispositions etc;
- (iv) section 165, which provides an exemption from rules relating to transactions at under-value, preferences and transactions defrauding creditors.

We understand that 'default rules' for these purposes means the rules of the CCP that *'provide for the taking of action in the event of a person ... appearing to be unable, or likely to become unable, to meet his obligations in respect of one or more market contracts connected with the ... clearing house, and in the case of a recognised central counterparty, "default rules" includes the default procedures referred to in Article 48 of the EMIR Level 1 Regulation'* (section 188(1)).

We recognise that HMT reads the reference to *'market contracts connected with the...clearing house'* to refer to all 'market contracts' in the chain from the indirect client to the CCP and we agree that this interpretation would make it possible to capture not only 'clearing member client contracts', but also the underlying 'client trades' that are connected with the contract cleared through the CCP. HMT goes on to say in its commentary that this would have the effect of capturing within the definition of 'default rules' any rules of a CCP that enable the CCP to take action against a party to such a market contract if the party appears unable, or likely to become unable, to meet their obligations in respect of the contract. It would be helpful if HMT could clarify if this would extend to circumstances where the CCP's rules and procedures do not specifically deal with a client default, but where the rules and procedures would provide a framework enabling the CCP to make the relevant transfers. We feel that this may be a difficult interpretation to reach on the basis of the current draft amendments themselves.

Although a CCP may include relevant procedures for a client default within its actual default rules, we would query whether HMT intends that such requirements will be imposed directly on UK CCPs (for instance, as part of the EMIR authorisation process) or whether will be left up to the discretion of individual CCPs (given that EMIR does not require this specifically in respect of a client default). In connection with this, HMT may wish to consider whether the Part VII amendments should be drafted so as to more clearly protect transfers in cases where the CCP's default rules do not specifically deal with a client default.

In respect of how a transfer of indirect client positions and assets would be effected, we thought it may be helpful to note the following:

- (i) In respect of a CCP omnibus account structure containing all the client's indirect clients' positions and assets, there may be a transfer of all those positions and assets to a back-up client or CM. If there is a back-up client or the same CM, the transfer would simply consist of a change to the existing account at the CCP (e.g. CM Client X (Indirect Clients) Account becomes CM Client Y (Indirect Clients) Account). We note that the meaning of 'transfer' in section 189A(3) has been extended to include 'an amendment of the clearing member client contract' and agree that this would cover this scenario. However, it is possible that the back-up arrangements would be with a different CM, in which case the accounts would need to be transferred to that back-up CM (with or without an underlying back-up client providing indirect clearing services). We understand that this would be covered by the provisions in section 189A(2), which include assignment and novation.
- (ii) There may be circumstances where the entire omnibus account is not capable of being ported to the same back-up client or CM, but where indirect clients instead have back-up arrangements with different clients or CMs. In such circumstances the positions and assets in the omnibus account would need to be split up. As would be the case in respect of partial transfers on a clearing member default, practical and other issues (including a potential shortfall in margin) may make porting more difficult to achieve in such circumstances.
- (iii) Although the EMIR technical standards only appear to require both individual and omnibus segregation to be offered to indirect clients at the client and CM level, it is possible that indirect clients may also request individual segregation at CCP level. Where this is provided, it may be easier for indirect clients to put in place individual back-up arrangements providing for the transfer of the positions and assets in their segregated accounts upon a client default.

In each of these scenarios, the CCP could effect the transfers pursuant to their default rules or other procedures in accordance with the instructions provided by the CM.

We understand that the intention is that the CCP level transfers of positions and assets envisaged in each of these scenarios would be protected under Part VII of the Companies Act 1989 as a transfer of 'clearing member client contracts' (i.e. the positions) together with a transfer of 'qualifying collateral arrangements' (i.e. the margin provided to the CCP) or, alternatively, a 'qualifying property transfer' (where the property transferred represents the termination or close-out value of the clearing member client contracts).

Where the CM and the client are acting as principal, the transfer of the 'client trades' corresponding to the 'clearing member client contracts' would also be protected, which would include both the contracts between the CM and the client and those between the client and the indirect client. The back-up porting arrangements would need to provide for such transfers to be made. We understand that it is the intention that a transfer of any margin provided to the client or CM in connection with such trades (e.g. any gross excess that has not been provided to the CCP) would also be protected as a 'qualifying collateral arrangement', although the agreement to provide for such transfers would have to be part of the back-up porting arrangements. It should be recognised that where gross excess margin is transferred by the CM, there may be circumstances where the CM would need to exercise

discretion as to exactly which assets should be transferred. Amendments may need to be made to Part VII to more clearly ensure the protection of the CM's determinations and the resulting transfers.

*(iii) Client and CM default*

In the case of a double default, the CCP will need to apply different procedures, which may build on those that already apply when a client or CM defaults. It is possible that the CCP will in such circumstances seek to engage with the indirect clients directly so far as is possible to make the arrangements for porting or to close them out where pre-defined time limits have been reached.

**2. *Does our approach provide a workable and effective protection for the transfer of indirect clients' positions?***

The transfers will only be protected under Part VII if they are made in accordance with the default rules of a CCP. It is therefore essential that it is made clear that the protections would also apply more broadly where the CCP's rules and procedures enable the transfers to be made. If that is the case, we believe the arrangements suggested may provide a protective legal framework for transfers, bearing in mind, of course, the practical challenges that could in any event arise around porting (not least, time sensitivity which is often hard to reconcile with the practical challenges facing a Liquidator/Administrator upon appointment as to information gathering etc so as to be in a position to make decisions) and the need for parties to have robust back-up arrangements in place.

**3. *How will indirect clients' positions be liquidated/settled? Does Part 7 need to be amended to provide any further protection? In particular, how could the amounts payable by the CCP on the liquidation of an indirect client account with the CCP be identified and handled? Under what circumstances could the indirect client receive them?***

This merits further consideration. There remain challenges in ensuring that entitlements of indirect clients (however defined by reference to relevant CCP rules and account structures) on a liquidation get back to those indirect clients without being locked up in the insolvency of an intermediary. That is a key element of the protections under indirect clearing constructs that is still unresolved.

In contemplating payment of entitlements to indirect clients, one must also be clear in considering, amongst other things (i) the nature of the entitlement – noting points about how collateral may transform and travel through the chain of intermediaries and (ii) the rights that intermediaries may look to assert over those entitlements to protect their own exposures.

It is clear that CM's will have a role in this process under Art 4(5) of the technical standards and we agree any payments made pursuant to that provision should be afforded adequate protections under Part VII.

It is possible that CCPs could make payments directly to indirect clients, but it is perhaps unlikely that they would have the information enabling them to do so, whereas it is envisaged that CMs will be provided with all the information held by a client in respect of its indirect

clients in the event of a default under Art 5(3) of the technical standards. Whether such data will be available in reality is questionable and we consider that it would be important to protect payments made by a CM from inclusion in the insolvency estate of a defaulting client even where the CM is not in fact able to identify and/or make payment directly to the indirect clients (see similar contemplation in Art 48(7) EMIR).

Additionally, in respect of a CCP omnibus account structure (where the positions of all the indirect clients of a client are in the same account), margin may be calculated by the CCP on a net basis whereas the CM may require margin in relation to the positions on a gross individual indirect client basis where there is an individual segregation account structure at the CM level. This means that there may be excess gross margin at the CM level, which would also need to be liquidated by the CM. HMT's assumption that any margin provided by the client to a CM would (more or less) be lodged with the CCP may therefore not always be correct.

We agree that where a CM acts as principal, any net sum from a termination or close-out of the positions with the CCP would be payable to the CM. Normally, the CM would then also pay a close-out amount to the client. However, this amount could be based on the positions and margins recorded in the accounts of the CM, which could include margin of a different type, or over and above (gross excess), that provided to the CCP. The amount payable to the client may also be subject to any other deductions the CM may be entitled to make in respect of those amounts.

However, in circumstances where the client is in default, it would be important to ensure that close-out amounts calculated by the CM are, where possible, paid directly to the indirect clients themselves to avoid such payments being caught up in the insolvent estate of the client. The exact processes for making such payments have not yet been determined. There may well then need to be an accounting as between the client and the relevant indirect client, where the indirect client has thereby received an "excess" over the amount actually owed to that indirect client by the client.

We agree that the technical standards would not permit CMs to mix or net the positions in an indirect client account with the positions of any other account and we understand section 182A(2) of Part VII has been drafted to ensure that nothing in the law of insolvency will enable such set-off either.

***4. Would the parties involved need or wish to put into effect effective arrangements in addition to the CCP procedures?***

The default rules or other procedures of the CCPs would be supported by the CMs procedures and instructions, as described above. Indirect clients and clients would also need to put in place appropriate back-up arrangements to support the transfer of positions or assets on a client default.

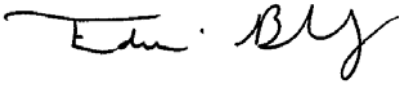
While the changes under discussion are welcome to extend the insolvency protections for indirect clearing, it is recognised that any changes made to UK law, will assist only UK domiciled indirect clients, indirect clearers and CMs. A scenario where all three entities are based in the UK is likely to be the exception rather than the rule. Accordingly, it is envisaged that a private law solution will be part of EU indirect clearing arrangements. Such a private

law solution may be Deed of Assignment in favour of the indirect client signed by both the indirect clearer and the CM.

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We welcome the opportunity to discuss the consultation paper and the above points in more detail with HMT.

Yours sincerely,



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