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8 October 2013

Dear Sirs

Re: Consultative report – Recovery of financial market infrastructures

The aforementioned consultation is welcome as it provides an opportunity to raise operational and legal issues of uncertainty which arise from the resolution and recovery of non-bank financial institutions.

The enclosed memorandum sets out a number of uncertainties. The points raised have been discussed by the Infrastructure Scoping Forum (the "Forum") of the Financial Markets Law Committee (the "FMLC"),[1] for which I act as chair on an occasional basis.

There is consensus within the Forum that further analysis of the issues set out would provide for greater legal and operational certainty and promote robust and stable financial markets.

If you believe that further work on the issues raised might be of assistance, the Forum would be very pleased to undertake a further examination of them.

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1 The Forum provides a space for discussion amongst representatives of market infrastructure bodies. Issues raised by the Forum are sometimes taken forward by the FMLC for action. The Forum's members are primarily in-house counsel from infrastructure bodies. It is chaired by lawyers in private practice on a rotating basis.

The remit of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. The FMLC has a website which can be accessed here – http://www.fmlc.org/Pages/papers.aspx.

I or members of the Forum would be delighted to discuss this letter and memorandum further. Please do not hesitate to contact me if you require additional information or assistance. I would be grateful if you could copy any response to this letter to fmlc@bankofengland.gsi.gov.uk.

Yours faithfully

Barnabas Reynolds

Infrastructure Scoping Forum – reforming points

This memorandum highlights the areas in which the Infrastructure Scoping Forum (the "**Forum**") consider there to be legal uncertainty and need for reform on CCP insolvency and related issues. The Forum noted nine such points of contention in their meeting on 21 May 2013.

1. PRE-DEFAULT STEPS

1.1 Following a push by their regulators, various UK-based clearing houses have introduced rules which are intended to have effect prior to the onset of insolvency proceedings affecting the clearing house. These include provisions to write down variation margin gains,[1] voluntary recapitalisation[2] (which may be during a period for which there is a suspension of clearing services)[3] and, in the event this fails, contract tear-up and termination of clearing services as if each clearing service were a segregated business.[4]

Interaction with insolvency law

1.2 There is some degree of legal uncertainty as:

(a) whether the pre-insolvency / pre-default steps taken by a CCP mentioned above may amount to a preference, transaction at an undervalue or transaction defrauding creditors for the purposes of sections 239 and 238 and section 423 of the Insolvency Act 1986 ("**IA 1986**"); and

(b) whether rules supporting such steps are "default rules" or the taking of such steps are "default procedures" for the purposes of section 157 of Part VII of the Companies Act 1989 ("**Part VII**") and hence protected from the effect of being a preference, transaction at an undervalue or transaction defrauding creditors for purposes of IA 1986.

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1 ICE Clear proposed rules 913 and 914, LCH.Clearnet Ltd Default Fund Rules supplements (Rule F9 of the ForexClear Default Fund Supplement, Rule S9 of the SwapClear Default Fund Supplement and Rule R9 of the RepoClear Default Fund Supplement), and CME Clearing Europe rule 8.6.

2 LCH.Clearnet Ltd Default Fund Rules supplements (Rule F10 of the ForexClear Default Fund Supplement and Rule S10 of the SwapClear Default Fund Supplement), and CME Clearing Europe rule 8.6.4.

3 ICE Clear proposed rule 915.

4 ICE Clear proposed rule 916, LCH.Clearnet Ltd Default Fund Rules supplements (Rule F11 of the ForexClear Default Fund Supplement, Rule S11 of the SwapClear Default Fund Supplement and Rule R11 of the RepoClear Default Fund Supplement), and CME Clearing Europe rule 8.10.

1.3 "Default rules" are defined in section 188(1) of Part VII as:

> *"[the] rules of a ... recognised clearing house which provide for the taking of action in the event of a person (including another ... recognised clearing house) 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 [EMIR]".*

1.4 The term "defaulter" is then defined in section 188(2) of Part VII as:

> *"a person in respect of whom action has been taken by a ... recognised clearing house under its default rules, whether by declaring him to be a defaulter or otherwise".*

1.5 There are two material issues with the Part VII provisions on default rules in the context of recovery rules, as summarised below:

(a) First, the definitions do not make it clear whether the term "default rules" can apply to rules that deal with the default of the clearing house itself or whether a "defaulter" can be the CCP itself. We are of the view that the relevant terms are best interpreted in a way that applies to a CCP's own default, as set out in our note on this topic dated 4 July 2013.[5] However, it would be helpful were the application of Part VII to a CCP's rules dealing with a CCP's own default to be expressly covered in order to remove any doubt;

(b) Secondly, the terms "default rule" and "defaulter" are also of unclear application where the rule in question is one which, if it achieves its purpose, would by definition avert a default. Rules providing for margin hair-cutting, suspension of contractual payments and deliveries and contract tear-up are intended to avoid a default and should do so in most conceivable factual scenarios. Such rules are more likely to be invoked by the CCP in the aftermath of a clearing member default causing significant losses. In this situation, the rules would certainly be characterised as default rules. However, if a loss were caused, for example, by the insolvency of a custodian or settlement bank used by the CCP or an act of fraud by an employee, the application of Part VII of is less clear. It would be helpful if Part VII expressly included pre-default rules designed to avert a default, so as to ensure that variation margin haircutting, suspension and contract tear-up are covered.

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5 See the following opinions: Norton Rose (http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/clearingeuropeltr072011.pdf); Shearman & Sterling (http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/iceclearеudcoapplicationmemo.pdf); and Clifford Chance (http://www.cftc.gov/files/tm/tmlchappendixd.pdf).

1.6 Similarly, the term "defaulter" includes someone in respect of whom "action" has been taken, either by declaring someone to be a defaulter "or otherwise". It would helpfully be clarified that the "or otherwise" part of the definition is intended to apply to actions taken under recovery rules.

1.7 In the event that one or more the steps in question constitutes a preference, transaction at an undervalue or transaction defrauding creditors but is not protected under Part VII, the legal efficacy of the step or steps taken by a CCP may be in doubt and subject to challenge. This will create uncertainty for the CCP and the financial markets more generally.

1.8 Tentatively, an FMLC paper or letter on this issue could recommend the passage of legislation to afford statutory protection to all relevant steps taken by the CCP, as set out in our note on this topic dated 4 July 2013.

Liability of CCP Directors/officers

1.9 There is uncertainty as to whether a CCP or its directors or officers could incur liability in contract, tort or otherwise for steps taken in accordance with a CCP's pre-default rules. Section 291 of the Financial Services and Markets Act 2000 ("**FSMA**") provides that "*a recognised body and its officers and staff are not to be liable in damages for anything done or omitted in the discharge of the recognised body's regulatory functions unless it is shown that the act or omission was in bad faith.*" It is not clear that actions in accordance with pre-default rules would be a "regulatory function".

1.10 The FMLC could suggest that clarity on this issue is required to ensure there is no CCP or individual director/officer liability for good faith execution of steps in accordance with pre-default rules (since otherwise the uncertainties as to liability would mean some of the above steps may not be taken in practice).

2. INITIAL MARGIN WRITE DOWNS

2.1 A requirement for initial margin-write downs, as proposed in paragraph 5.3 of the Bank of England's Financial Stability Paper No. 20 (the "**CCP Rules Paper**") will lead to regulatory capital uncertainties for clearing members.

2.2 If initial margin is written down, additional margin would need to be provided to cover unsecured positions, which could also then be written down. Initial margin write-downs could therefore introduce uncapped liability, which is contrary to Article 43(3) of Regulation No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**").

2.3 FMLC could respond to the CCP Rules Paper and highlight the possible danger of initial margin write downs leading to uncapped liability, contrary to EMIR, and recommend that the measure is not adopted.

2.4 In contrast, variation margin write-downs do not give rise to the same concerns, because this would result only in an unrealised gain.

3. THE CLEARING OBLIGATION OF AN INSOLVENT CCP

3.1 Article 4(1) of EMIR provides that "*counterparties shall clear all OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation*". Pursuant to Article 14 of EMIR, CCPs are authorised to clear particular classes of financial instrument. There is uncertainty as to whether the clearing obligation in relation to a particular product cleared only or predominantly by one CCP, ceases upon the insolvency of that CCP for the purposes of the clearing obligation.

3.2 In the event of an insolvency of a CCP, numerous trades between counterparties could become void if the clearing obligation does not cease at the point of the CCP's insolvency and no alternative clearing mechanism is available.

3.3 FMLC could highlight this issue and propose a mechanism by which CCPs would be obliged to make arrangements for another CCP to step in and clear outstanding trades on their behalf if they become insolvent and whereby market participants would not be in breach of EMIR if the sole CCP for a product becomes insolvent. We note that the "reserve" CCP would need the requisite authorisation to clear the relevant products pursuant to Articles 14 and 25 of EMIR.

4. INSOLVENT CCP'S IMPACT ON CLEARED TRADES

4.1 There is uncertainty as to whether a trade that was cleared with a CCP that subsequently became insolvent would count as a cleared trade for purposes of Article 4 of EMIR.

4.2 If it is the case that cleared trades will not be deemed to be cleared following the insolvency of the CCP that cleared the trade, the validity of many trades could come under threat subsequent to such insolvency.

4.3 FMLC could suggest that clarification is required as to whether these cleared contracts between clearing members are still effective, and could recommend that legislative provision is made to clarify that once a trade has been cleared it has been so definitively, regardless of the subsequent insolvency of the CCP that cleared it.

5. SCOPE OF BAIL-IN TOOL

5.1 There is uncertainty as to whether the bail-in tool, as set out in the proposed directive establishing a framework for the recovery and resolution of credit institutions and investment firms (the "**RRD**"), can only be applied to a CCP's indebtedness for regulatory capital purposes and not for liquidity purposes pursuant to Article 44 of EMIR or in fulfilment of any other regulatory obligation. Article 37 of the RRD states that bail-in can be used by the resolution authorities of Member States to:

(a) recapitalise an institution that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation and carry on its activities for which it is authorised; or

(b) convert to equity or reduce the principal amount of claims or debt instruments that are transferred to a bridge institution with a view to providing capital for that bridge institution.

5.2 If the bail-in power is permitted to be used against a CCP's liquidity facilities, this could hinder a CCP's ability to secure such financing. A CCP could therefore be at risk of breaching Article 44 of EMIR, which requires a CCP to have at all times access to adequate liquidity to perform its services and activities.

5.3 The FMLC could call for clarification on the extent that the proposed bail-in tool would apply to CCPs setting out the issues in applying this to liquidity lines.

6. BRIDGE INSTITUTION TRANSFER MECHANISM

6.1 Uncertainty exists as to:

(a) whether implementation of the bridge institution transfer mechanism in the European Commission's Proposal for a recovery and resolution framework for financial institutions other than banks could be achieved in the suggested timeframe of a weekend. The three month period for the approvals of default rules in Part VII[6] would be a barrier to this (although a shorter period can be agreed if appropriate). Regulatory approval of the new bridge institution would also take much longer than this if carried out in accordance with the relevant provisions. The procedure for authorisation of a CCP under Article 17 of EMIR and Section 288 of FSMA requires the CCP to provide "all information necessary" to satisfy the competent authority that it satisfies the EMIR requirements. The same procedure applies pursuant to Article 15 where a CCP wishes to extend its business to additional services or activities not covered by the initial authorisation. These requirements may have to be waived or disapplied in the case of transfer to a bridge institution; and

(b) Article 25 of EMIR provides that a CCP established in a third country may provide clearing services to clearing members or trading venues established in the EU only where it is recognised by ESMA. Recognition can only be granted where the Commission has adopted an implementing act determining that the legal and supervisory requirements of the third country are equivalent. The applicant CCP must provide ESMA with all information necessary for its recognition. The recognition of a third country bridge institution transfer process is therefore also uncertain, both in respect of the need to assess whether the process is equivalent to similar EU mechanisms and the feasibility of recognising the transferee institution in a short time period.

[6] Section 157.

6.2 These issues raise questions as to whether this mechanic is inherently too uncertain and unlikely to work for the financial markets in the context of a CCP insolvency.

6.3 The FMLC could outline these issues and suggest the need for coordination of the approval and authorisation mechanisms.

7. STATUTORY REGIME FOR CCP INSOLVENCY

7.1 Legal uncertainty results from there not being any specific statutory regime for CCP insolvency. Part VII is limited in scope.

7.2 The FMLC could consider querying if there should be a comprehensive statutory provision for CCP insolvency, which should give effect to CCP default rules covering the methodology for the valuation of positions, margin and resulting net sums, and also the basis for distribution to clearing members and their customers. The regime could also recognise and bolster the existence of bankruptcy-remote margin protection vehicles, giving the executives running those vehicles the ability to distribute assets in accordance with the CCP's insolvency rules.