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**Preliminary response to HMT Informal consultation on indirect clearing arrangements**

We welcome the HMT Informal consultation on indirect clearing arrangements of 28 March 2013 and the intent to provide, so far as is possible, a protective framework for EMIR compliant indirect clearing constructs in the UK (noting that these will only be helpful in respect of the UK insolvency regime).

We are grateful for the opportunity to meet with you and discuss these matters further. Ahead of that, and in light of the 15 April 2013 response deadline, we thought it helpful to note our initial views. We look forward to discussing these further and are pleased that a subsequent round of informal consultation is proposed.

Before we address the specific questions posed in the consultation paper, we would like to highlight a number of issues.

1. ***What indirect clearing requires - the policy view expressed in the consultation***

We support HMT's approach of facilitating porting and liquidation of indirect client's accounts on default of the client of the CM through legislative amendment of relevant UK insolvency law, and note that such amendments should not have the effect of requiring indirect clearing to take place in accordance with a particular approach.

With this in mind, we think it is important that this consultation does not effectively create policy on what constitutes an EMIR-compliant indirect clearing construct between CM, client of CM and indirect client. In particular, we believe any legislative amendments should support both 'agency' and 'principal' constructs as well as permitting development of other models and do not believe that Level 2 requirements favour one construct over another. For example, Art. 5(1) of the RTS requires the indirect clearer to offer alternative account segregation options through its own records (which may be redundant in an 'agency' construct), and the draft proposal by ESMA for a 30-day holding period for CMs to assume indirect clients' positions was removed following industry concerns about CMs having to face indirect clients.

It would be helpful therefore if HMT could confirm that the consultation paper's focus on agency-based arrangements is not intended to indicate any HMT policy to prohibit riskless principal or other models, but rather a view that an agency construct is the style of indirect clearing construct which lends itself most easily to protection via Part VII CA 1989.

In summary therefore, whilst an indirect clearing arrangement should afford indirect clients the protection required by EMIR whilst allowing the indirect client to preserve its relationship with the indirect clearer, this protection should be achieved without putting the CM in any worse situation when compared with its dealing with a direct client where the CM is free to select its own contractual model when facing the direct client. As a practical matter, regulating this level of relationship (for example by favouring a particular contractual model, or prescribing default procedures which must be adopted by participating CMs) would be a barrier to CMs and indirect clearers wishing to participate in indirect clearing arrangements. It should be possible to frame amendments to UK insolvency law around these principles.

### *2. Agency vs principal arrangements at indirect clearer level - the substantive conclusion*

On the substantive conclusion HMT expresses, we do not believe that the language of the RTS is in any way determinative of this. The expressed aim of ESMA was indeed to retain sufficient flexibility to allow the industry to design commercially viable models. Without rehearsing the arguments in full:

There are a range of reasons why European clearing constructs have not historically used an agency model in the CM-client context. One of those issues relates to CCP concerns in becoming directly exposed to end-clients in any number of jurisdictions (wherever a CM chooses to take on clients). Such concerns remain equally relevant for the CM that may only offer indirect clearing on an agency-basis, where the nature and identity of the indirect client becomes important for a variety of reasons. See sub-heading (3) and (4) below.

In addition, an 'agency' construct may necessitate the CM to undertake pre-default due diligence (e.g. KYC, AML) upon each indirect client similar to that which it would undertake on a direct client. This in turn may impede the timely establishment of the indirect clearing arrangement as compared with a 'principal to principal' model .

In addition, it should not be necessary for the indirect clearer to disclose details of its indirect clients as a prerequisite to setting up the arrangement, although this would need to be addressed in the event of an indirect clearer's default as per Article 5(3) of the RTS. It should be possible to estabalish the arrangement in such a way as to preserve the relationship between indirect clearer and the indirect client.

### *3. Regulatory capital and netting implications*

If the CM is effectively facing the indirect client, CM may well have a different (and more expensive) regulatory capital outcome than would be the case if it were facing the indirect clearer as principal. Since the CM also has an exposure to the indirect client in relation to transactions, it would need to put in place effective close-out netting arrangements facing the

indirect client (which are insolvency-robust in the jurisdiction of the end-client) for regulatory capital purposes. This could be a major undertaking depending on the jurisdictions from which the indirect clearer took on clients - by contrast to the position on a riskless principal basis where the CM could clearly treat the indirect clearer as its counterparty for these purposes.

***4. Handling of collateral***

The assumption that "all of the indirect clients' margin will need to be passed up to the CM" (p.2) is incorrect and oversimplifies the collateral arrangements of these constructs. There may well be a need or desire for collateral transformation,pre-funding or other "adjustments" at various levels in the chain. It is also true that both the CM and the indirect clearer will want to look to the relevant collateral for their own exposures and there will be challenges around how this is achieved in an efficient and effective manner (including for regulatory capital purposes). It is therefore important not to be too prescriptive.

***5. Cross-border arrangements***

Any indirect clearing solution needs to be workable in respect of CMs and indirect clearers in jurisdictions other than England / in relation to non-English law insolvency regimes. Whilst Part VII amendments would be welcome where they can support this, it should be acknowledged that they are unlikely in themselves to be a complete solution and should not therefore direct the way in which indirect clearing is designed across the Union (and indeed, outside it).

***6. Implementation intentions in other EU member states***

We would welcome consideration of equivalence in other EU jurisdictions, in particular whether other jurisdictions are implementing similar protections, or issuing similar interpretations of compliant constructs, that would encourage a consistent and supportive environment for indirect clearing. We would wish to ensure consistency and avoid the situation where other member states take a more flexible view and leave UK institutions at a competitive disadvantage in designing indirect clearing offerings.

***7. Powers of direction over clearing members***

While it may be appropriate to allow an extension of s.166 powers to insolvency office-holders appointed in respect of a defaulting indirect clearer, in the same way as they apply to a defaulting CM, extending such powers to the CM itself would be a point of concern to CMs, given the sort of unspecified powers of direction the regulator may have in relation to intermediaries.

CMs are not central counterparties requiring authorisation or recognition, and as such do not maintain "default rules". An indirect clearing construct is likely mostly reliant on contract, so that "regulatory approval" would not be pertinent.

Our understanding of HMTs proposed approach is that CMs may establish certain processes (query whether this will be optional, or will be mandatory based on some set of CCP-like criteria that have yet to be determined) which will be designated by the PRA as attracting Part VII protections. Whilst it may be appealing to have additional UK legislative support for structures intended to ensure assets get back to their intended recipients on an intermediary failure, such support should not come with conditions that are so onerous as to undermine the likelihood of intermediaries being willing and able to offer such services.

***8. Cross border non-EEA structures***

One of the key drivers for the inclusion of indirect clearing in EMIR is in relation to EU investors' access to US clearing infrastructure (whilst we refer to the US, we note that the issue is likely to be relevant to other non-EEA infrastructure and clearing members, for example in the Asian markets).

Current EU financial services licensing regimes mean that if a non-EEA based clearing member would need to consider local licensing requirements in each relevant Member State in order to be in a position to offer clearing services to EEA-based clients. By way of example, current futures business may operate an indirect clearing model, whereby the EEA client contracts with an EEA broker (acting as a riskless principal) who in turn has an account with the US clearing member which accesses the CCP, to take advantage of "passporting" arrangements available to the EEA broker. The EEA client has no contractual nexus with the US clearing member and does not end up being party to any transactions with the US clearing member.

If one requires the indirect clearer (i.e. the EEA-based broker) in this context to act on an 'agency' basis that may expose the non-EEA clearing member to EEA licensing concerns. In short, it would make such services non-viable for EMIR business. Whilst this particular concern is mitigated by the trend for CCPs to offer clients a choice of venue to clear the same derivative product (for example where an identical OTC derivative instrument may be cleared either on a CCP's US platform or on its EEA platform) we believe the amendments should take into account this required flexibility for future clearable instruments which may only be cleared in one jurisdiction, outside EEA.

***9. Achievability of individual segregation indirect clearing arrangements***

Whilst we appreciate that this paper is focussing on UK legal issues, it does not address the likely achievability of individual segregation at an indirect level under structures which are available in the market (for instance, LSOC models in a US-context). We believe however that it needs to be borne in mind that indirect clearing was intended to offer a flexible range of services and that omnibus constructs may in fact be the more commercially viable and useful elements of any indirect clearing structure.

**HMT Questions**

*1. Do we agree the Direct Client will always act as agent?*

No – as above, we think the direct client should be able to act as principal, using security interests or trust structures to address any concerns about mandatory insolvency set-off or other challenges on insolvency of the direct client.

*2. Do we agree that net omni accounts cannot be operated by the direct client where the direct client acts as agent?*

Yes. However, this is a practical consequence of the CM collecting margin on a 'net' basis, rather than an interpretative requirement of L2 Art. 4(2) and 5(1). Operating a 'net' omnibus model would risk mutualising losses upon a direct client default, which is not the intention, and it would also not be able to port the collateral properly upon a direct client default due to lack of certainty over which item of collateral relates to which indirect client's positions, unless all indirect clients port together to the same transferee direct client.

*3. Do we agree with the assumptions made about provision of margin by indirect client clients to clearing members?*

No – we do not believe L2 Art. 4(5) requires margin to be delivered directly by indirect client to CM. CMs will generally prefer to take the credit risk of the direct client – that means the direct client will have to provide CM with margin, rather than margin coming directly from the indirect client. It would create significant operational issues for CMs if CMs were required to receive margin directly from indirect clients and if CMs were required to pay excess margin directly back to the indirect client.

*4. Do we agree there is no need to exercise regulatory control over the default rules and procedures of the clearing members?*

Yes, as above.

*5. Do we agree with HMT approach to segregation?*

Yes

*6. Do we agree with HMT approach to the transfer and liquidation of indirect clients' accounts?*

Yes.

*7. Do we have any views on how Indirect Clients' positions might be transferred to a different clearing member on the default of the Direct Client?*

The challenge here, given the size of the indirect clients, is whether those indirect clients will have a relationship ready-papered with a back-up broker to ensure portability of positions to their back-up broker. If not, then the clearing members do need to have a transparent liquidation process.

*8. Do we consider that a clearing member may, upon liquidation of the indirect client positions, hold the corresponding positions at the CCP as house positions?*

Yes, this is part of the close out methodology for certain CCPs (e.g. LCH.SwapClear)

*9. Do we agree with HMT's approach to the return of excess collateral?*

No. It is predicated on the margin being the same all the way down the chain (from indirect client through to CCP) and that the same haircuts are applied all the way along the chain. This may not be the case in either instance (nor does EMIR appear to require that it is the case), given that CMs do not outsource their risk management to CCPs (and accordingly reserve the right to apply their own haircuts to collateral) and the indirect/direct client may require collateral transformation services from the CM.

*10. Is any particular provision needed for double default, beyond that proposed for client default?*

This is acknowledged to be a remote event. The issue is segregation by value vs segregation by asset under EMIR, especially if the CM placed different collateral at the CCP from what the indirect client originally provided. The CCP needs to have clear rules about what action it will take in the event of a double default.

*11. What financial costs will we incur due to domestic implementation of indirect clearing arrangements (as opposed to those related to EMIR implementation)?*

It is difficult to assess these exhaustively as they are largely dependant on the form of indirect clearing arrangements adopted and will be different for CMs, indirect clearers and indirect clients . By way of example, however, CMs may incur additional costs including regulatory capital charges, increased CCP default fund and operational costs as a result of implementing indirect clearing arrangements.

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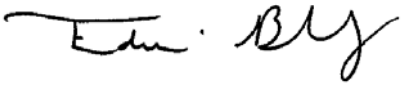
We welcome the opportunity to discuss the consultation paper and the above points in more detail with HMT.

Yours sincerely,



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