CLIFFORD
CHANCE

Transaction Services Newsletter June 2012

Transaction Services Newsletter

Why you should be afraid of clients with money: a shaggy dog story

EastEnders is a UK TV show whose logo features the "Isle of Dogs" where the Lehman Brothers' London offices were located. Plot developments are absurd but entertaining; this article is to help you catch up, in case you missed an important twist. It's the decision of the UK Supreme Court in the never-ending Lehman Brothers soap-opera of litigation on the "question of client money". The problem, in a nutshell, is this: how can I be sure that a financial institution client who gives me cash collateral is giving me "clean" collateral which is not going to be whisked away if the client defaults?

How the problem arises

In the latest episode the Supreme Court ruled that financial firms who use a methodology called the "alternative approach" are mixing client money and proprietary money intra-day in their "proprietary" accounts. This happens because these firms are allowed to compute the amount of "client money" they are supposed to be holding for their customers at the end of the day, and then move into their segregated "client money" bank account at their bank enough funds to ensure that the client money bank account has a sufficient balance to equal all the firm's client money obligations. The idea is that the funds in the client money bank account constitute a pool from which the customers can recoup their "client money" funds – and the pool stands outside the insolvency estate in the horrible event of the firm's insolvency.

> "how can I be sure that a financial institution client who gives me cash collateral is giving me "clean" collateral which is not going to be whisked away if the client defaults?"

The Supreme Court also ruled that the pool of "client money" includes sums which happen to have been credited to the proprietary account intra-day, but which fall within the definition of "client money" under the FSA's client money rules. This means, then, that if a customer of Lehman paid €5000 for the purchase of some securities on the Friday before Lehman collapsed, the €5000 was sitting in Lehman's *proprietary* account at the moment Lehman went bust, because the "end-of-day" true-up was in fact going to take place first thing on Monday, and Lehman had gone bust over the weekend. The Supreme Court's ruling means that a) the customer has a "client money" claim against the client money pool, but b) (and this is the bit which strikes fear into the heart of collateral-takers) the client money pool *includes the bits of client money still credited intra-day to the proprietary account.*

Credit risk

Collateral-takers may be fearful because they are relying on "proprietary" cash accounts of financial firms as cash collateral. Historically deposit-takers could draw reasonable comfort from the absence of a "client money letter" which identified a client money bank account and asked the deposit-taker not to exercise set-off rights against that account – thereby keeping the client money safe for

Contents

Editor

Dermot Turing
E: dermot.turing@cliffordchance.com

Transaction Services Contacts

Simon Crown
E: simon.crown@cliffordchance.com

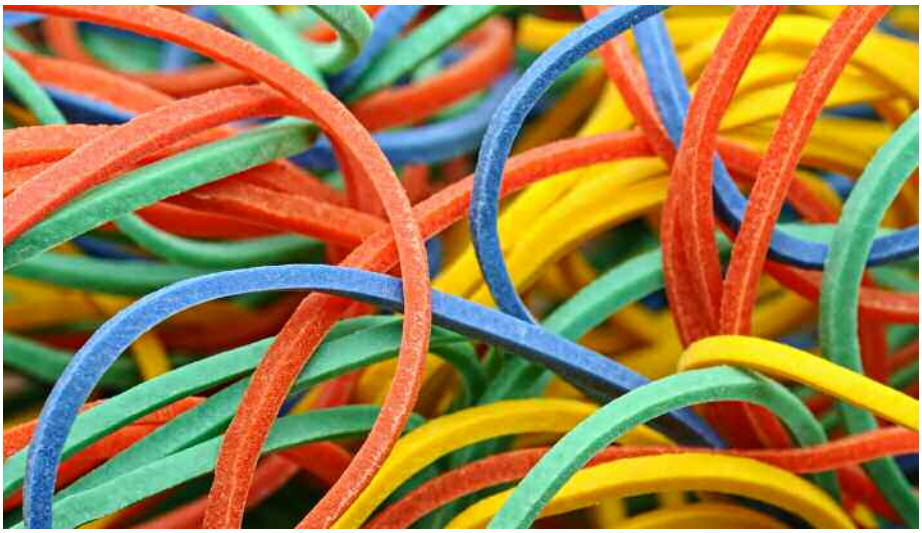
Simon Gleeson
E: simon.gleeson@cliffordchance.com

Caroline Meinertz
E: caroline.meinertz@cliffordchance.com

Nick O'Neill
E: nick.oneill@cliffordchance.com

Monica Sah
E: monica.sah@cliffordchance.com

Jeremy Walter
E: jeremy.walter@cliffordchance.com



customers, and segregated from deposits which could be used as collateral. But after the Supreme Court judgment, the proprietary accounts might also contain client money.

So where does that leave set-off rights, and rights of third-party collateral-takers, relying on cash deposits placed by financial firms who are subject to the client money rules? If a firm is known to be using the "alternative approach" and the account in question is a "proprietary" account, is the cash "clean" or is it as risky as a second-hand car bought from an East End salesman with a reputation for tweaking the mileage meter? And if the collateral-taker knew that the firm was using the alternative approach, does that mean that the whole cash balance could be taken away by the administrator if the firm goes bust, even if only part of the balance was not-yet-segregated client money?

Unfortunately English law – already battered and bruised from the onslaught in 2011 on securities collateral created by the new edition of the Financial Collateral Regulations (see episode 6 of Transaction Services Newsletter) – now has to look hard at the reliability of cash collateral.

The customers of financial firms also need to worry about this, too. There is a perception that "client money protection" should be effective to keep money sent to a non-bank firm out of the firm's insolvent estate, and that should give the customers superior rights. The Supreme Court has tried to underpin this perception by including the money temporarily lodged in proprietary accounts within the client money pool. But if collateral-takers can assert superior collateral rights over proprietary accounts, the customers are back where they were before the ruling.

The way forward

In our opinion the client money rules are in desperate need of an overhaul, and to be fair the script-writers at the FSA acknowledge this. They're working on a new story-line which, it is hoped, will bring more clarity to the narrative of client money for all concerned. We also hope that the FSA will remember that counterparties of financial firms need to have reliable ways of taking cash as collateral, and that their new rules will accommodate this in a clear and understandable way. This is in the interests not just of collateral-takers, but also of collateral-providers, who would strongly object to having to lock away valuable assets in order to obtain vital credit lines to facilitate their everyday business.

Clifford Chance paper:
http://www.cliffordchance.com/publicationviews/publications/2012/03/the_lehmans_supremecourtjudgmentandclien.html

Elastic is good, but can be a tight fit

The British are proud of their inventions during the industrial revolution. As well as steam trains and iron bridges, there is a theory that they invented the rubber band. The power of elasticity has, however, moved over to the Committee on Payment and Settlement Systems (CPSS), who are based in Switzerland, and who together with IOSCO have issued a definitive set of Principles for Financial Market Infrastructures.

The CPSS has the job which is roughly equivalent to what the Basel Committee does for banks: to issue supra-national guidance or quasi-regulations on payment and securities settlement systems, with a view to enhancing systemic stability. They have previously issued recommendations for operators of systemically important payment systems, securities settlement systems, and central counterparties; and now they have repealed all that and reissued everything under a single pair of covers. The new Principles cover trade repositories and central securities depositories as well as payment systems, securities settlement systems and CCPs. They have been modernised and it is evident that the CPSS listened carefully to the comments

which were made on their 2011 consultation version.

In outline, the 24 Principles addressed to infrastructures cover nine topic areas: law, governance and risk management; credit and liquidity risk; settlement; CSDs and CLS; default management; business and operational risk; access criteria and interoperability; efficiency; and transparency rules for trade repositories. All this is to be welcomed, and the 120-odd pages of explanatory text will provide useful guidance to participating firms on questions of risk management as much as they will set the regulatory agenda for infrastructures.

So why does all this merit a column in Transaction Services Newsletter? What worries us is that the new rules are, by and large, a "one-size" solution where it is assumed that an elastic approach will expand or shrink to fit all types of infrastructure. That must be wrong, we think, as a matter of principle. CCPs and some payment systems take on credit risk; CSDs and many other payment systems do not. CCPs may interoperate but payment systems and securities settlement systems rarely do, but when they do so the structures and risk issues are different from those in CCP interoperation. Default management styles will need to be different for different types of infrastructure. Publicly-owned systems raise different risk and governance issues from for-profit private systems, and vertical silos should not be treated the same as horizontally integrated systems. We could go on.

"infrastructures will have to overhaul their own rulebooks, imposing cautious standards on their members ostensibly in the name of risk-management."

Elastic bands can ping back painfully. And that is really why the one-size approach may be wrong. Infrastructures, and their regulators, will now face pressure to abide by the CPSS Principles, because like Basel Committee rules they constitute the entry-level for regulatory rulebooks. And that means that infrastructures will have to overhaul their own rulebooks, imposing cautious standards on their members ostensibly in the name of risk-management. Each of the CPSS standards is likely to be very sensible for one infrastructure type but should not be mindlessly stretched out to encompass everything. To be fair to the CPSS authors, they have been conscious of this, and none of the Principles is written in mandatory language. So we have a suggestion, to keep infrastructures from overstretch: "*the [infrastructure's] design, rules, overall strategy, and major decisions [should] reflect appropriately the legitimate interests of its direct and indirect participants and other relevant stakeholders.*" CPSS Principle 2, key consideration 7.

CPSS Principles www.bis.org/publ/cpss101.htm

Market Developments
Payments and Cash Management

1. SEPA Regulation

The regulation establishing technical requirements for credit transfers and direct debits in euros, which sets out EU-wide end-dates for the migration of the old national credit transfers and direct debits to the Single Euro Payments Area (SEPA) instruments, has been published in the Official Journal. It's going to have significant operational and controls-related impact on payment service providers, as well as abolish "interchange fees" for direct debit save in exceptional cases.

Regulation
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:094:0022:0037:EN:PDF

2. Washing Machine

The anti-money-laundering machine continues on its high-spin cycle, scattering new initiatives by the basket-load. Here is a laundry list of recent developments:

The European Commission intends to bring forward a proposal for a fourth anti-money laundering Directive in autumn 2012. The Commission has invited responses to its report by 13 June 2012.

Report
ec.europa.eu/internal_market/company/docs/financial-crime/20120411_report_en.pdf

The Joint Money Laundering Steering Group (JMLSG) has published revised guidance on electronic money.

Link to guidance
www.jmlsg.org.uk/industry-guidance/article/jmlsg-guidance-current

The significant personal responsibilities of money laundering reporting officers has been highlighted by the first fine imposed on an individual to arise from the Financial Services Authority's thematic review into authorised firms' compliance with their AML obligations. On the other hand, the UK High Court has rejected a long running challenge by former customers to a bank's decisions to make Suspicious Activity Reports, in a decision that recognises the delicate balance that MLROs are required to strike between their own and their institutions' competing legal and commercial obligations.

Clifford Chance briefing paper on these developments:
www.cliffordchance.com/publicationviews/publications/2012/05/a_mixed_report_formoneylaunderingofficers.html

3. e-Payments

The European Central Bank (ECB) has published for public consultation a set of recommendations for the security of internet payments. There are three groups of recommendations:

- general control and security environment of the platform supporting the internet payment service – recommendations relate to governance, risk identification and assessment, monitoring and reporting, risk control and mitigation issues as well as traceability.
- specific control and security measures for internet payments – recommendations relate to the steps of payment transaction processing, from access to the service (customer information, enrolment, authentication solutions) to payment initiation, monitoring and authorization.
- customer awareness, education and communication – recommendations relate to unexpected requests for security credentials, how to use internet payment services safely and how customers can check that a transaction has been executed.

Comments are due by 20 June 2012.

ECB's Recommendations:
www.ecb.int/pub/pdf/other/recommendationsforthesecurityofinternetpaymentsen.pdf?9556ffd35a19e41fe1d8f2bbb238b847<http://www.ecb.int/pub/pdf/other/recommendationsforthesecurityofinternetpaymentsen.pdf?9556ffd35a19e41fe1d8f2bbb238b847>

There's also a lot more going on in this space. The European Commission has plans to allow more competition into the payments processing area, including the e-payments space, as indicated in its Green Paper of January. The Committee on Payment and Settlement Systems (CPSS) has published a report on innovations in retail payments. And there is a paper out from Eurasia Insights on the relationship between social media and payments.

Commission's Green Paper: eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52011DC0941:EN:NOT (consultation closed in April)

CPSS Report: www.bis.org/publ/cpss102.pdf

Social media: socialmedia.eurasiainsights.com/SMP_WhitePaper_C.pdf

4. Rhythm M Blues

The coolest currency these days is the renminbi. Lots of groovy initiatives are coming from Hong Kong and London on offshore RMB.

The Hong Kong-London Forum, jointly established by Hong Kong and the United Kingdom in January 2012 to promote closer collaboration between Hong Kong and London in support of the wider international use of RMB, held its first meeting in May. Forum participants agreed to take action on supply of liquidity, payments and settlements, and products and market services.

The Hong Kong Monetary Authority (HKMA) has issued a circular announcing its decision to allow individual authorised institutions to determine their own RMB net open position limit by taking into account the nature and scale of their RMB business.

HKMA Circular: www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2012/20120522e1.pdf

Two Clifford Chance briefings on RMB:

London Perspective:
www.cliffordchance.com/publicationviews/publications/2012/05/renminbi_internationalisationthelondo.html

Regulatory developments over three years:
www.cliffordchance.com/publicationviews/publications/2012/05/renminbi_internationalisation-marketan.html

5. Switch

According to the concise Oxford English Dictionary, a "switch" is a flexible shoot cut from a tree which can be used as a whip. The EU Commission has launched a consultation to gather stakeholders' views on the need for action and on possible measures to be taken in relation to the transparency and comparability of bank account fees, bank account switching and access to a basic payment account. Banks may feel they are being beaten up on this issue: the Commission notes that national initiatives have had varying degrees of success, with the result that consumers in different countries enjoy different levels of protection. The consultation period ends on 12 June 2012.

The UK's Payments Council also launched a switching initiative with an intention of having banks comply by September 2013.

Commission's Consultation paper:
www.ec.europa.eu/internal_market/consultations/docs/2012/bank_accounts/bank_accounts_consultation_en.pdf
www.ec.europa.eu/internal_market/consultations/docs/2012/bank_accounts/bank_accounts_consultation_en.pdf

UK PC webpage: www.paymentscouncil.org.uk/current_projects/account_switching/

Securities services

1. More UK agony on client assets

The Financial Services Authority continues its effort to spell out the role custodians will have to play in helping other firms with their "resolution and recovery plans". If something fatal happens to a financial firm which has placed client assets and client money with a third party, it needs to be able to explain instantly to the administrator what it holds and where. This is something which needs to be done in conjunction with the third party bank or custodian in question. The FSA has published a policy statement (PS12/06) which sets out the FSA's final rules requiring certain firms to maintain and be able to retrieve a "CASS Resolution Pack", which contains documents and records that would help an insolvency practitioner return client money and safe custody assets more quickly following an investment firm failure. Firms have until 1 October 2012 to comply with the CASS Resolution Pack rules.

FSA paper PS12/06: www.fsa.gov.uk/static/pubs/policy/ps12-06.pdf

2. Cover your eyes and ears

Section 23A of the US Federal Reserve Act generally imposes certain limitations on "covered transactions" between banks and their affiliates. The Volcker Rule introduced by the Dodd-Frank Act takes things one step further, prohibiting outright "covered transactions" between a banking entity (i.e., any entity that is part of a banking organization subject to the US Bank Holding Company Act) and a Volcker Rule covered fund that is: (i) advised by the banking entity or any of its affiliates; or (ii) organized and offered, or sponsored by the banking entity or any of its affiliates. Covered transactions include, among other things, extensions of credit, purchases of assets, and guarantees. Thus, a banking entity may not extend any credit to a covered fund, with which the banking entity has an advisory or other relationship permitted under Volcker. Hence it appears that custodial services to a covered fund, with which the banking entity has an advisory or other relationship permitted under Volcker, would most likely have to be limited to exclude extensions of credit or pushed to third party providers. So far it is uncertain what the final implementing regulations would look like, but this one might be important for inter-affiliate custody services.

Clearing

1. About time, too

The G20 commitment was to force derivatives into clearing by the end of 2012. The clock is ticking away as that deadline gets closer. After a painfully drawn-out legislative process the final text of EMIR – the EU's Regulation on OTC derivatives and clearing, and regulation of CCPs, was agreed in March. What needs to happen for it to become law is publication in the EU's Official Journal. But most of the provisions which have real bite can't take effect until CCPs have obtained authorisation under the Regulation – which will be another drawn-out process, because authorisation requires the establishment of multi-country colleges of regulators. Meanwhile, the European Supervisory Authorities (EBA and ESMA) are due to produce draft Level 2 legislation. Keep watching the clock, but we suspect that sands may run out on the G20's hourglass before the whole of the EMIR legislative package is in force.

Final compromise text
register.consilium.europa.eu/pdf/en/12/st07/st07509-re01.en12.pdf

2. Meanwhile in America

The Commodity Futures Trading Commission (CFTC) has adopted final regulations regarding the documentation between a customer and a futures commission merchant and clearing member risk management for swap dealers, major swap participants, and FCMs that are clearing members. In particular, the risk management rules require clearing members to:

- establish credit and market risk-based limits based on position size, order size, margin requirements, or similar factors, and monitor for adherence to the limits both intra-day and overnight;
- conduct stress tests of all positions in the proprietary account and all positions in any customer account that could pose material risk to the FCM at least once per week, and evaluate its ability to meet margin requirements at least once per week, and test all lines of credit at least once per year.

The CFTC and Securities and Exchange Commission (SEC) have also adopted final rules adding further details to and guidance on various definitions: swap dealer; security-based swap dealer; major swap participant; major security-based swap participant; and eligible contract participant.

Clifford Chance has prepared a briefing paper focusing on each of the three main entity definitions adopted by the Commissions, as well as the exclusions and safe harbours described in the final rules and interpretive guidance that was included in the adopting release.

CFTC FCM Fact sheet:
www.cftc.gov/ucm/groups/public/@newsroom/documents/file/ccd_tac_cmrm_factsheet_final.pdf

Clifford Chance briefing on definitions:
www.cliffordchance.com/publicationviews/publications/2012/05/cftc_and_sec_adoptfinalentitydefintionrule.html

3. And down under

The Australian Council of Regulators has published a report on the implementation of G20 commitments on over-the-counter (OTC) derivatives in Australia. It has also published a framework implementation paper for consultation.

Consultation paper
www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Over%20the%20counter%20derivatives%20commitments%20consultation%20paper/Key%20Documents/PDF/OTC%20Framework%20Implementation_pdf.ashx

4. Product eligibility for UK clearing

The Bank of England is going to become the regulator of CCPs in the UK once the Financial Services Bill completes its passage – it's currently in the House of Lords. The Bank has published a paper setting out its views on eligibility of OTC derivatives for clearing.

Paper

www.bankofengland.co.uk/publications/Documents/fsr/fs_paper14.pdf

J201206010041182