C L I F F O R D
C H A N C E

Transaction Services Newsletter

October 2012

London Olympics 2012 Special

This issue is unashamedly about London 2012. Not to be out-done by the athletes and paralympians, the UK's regulatory bodies have spent the summer working on some record-breaking initiatives. The impact of these developments is going to reach well beyond the shores of Britain....

Depositor preference

"Depositor preference" refers to a type of insolvency law which states that depositors rank first in the queue of creditors to receive a pay-out from an insolvent bank. The challenge with depositor preference is that some countries' laws discriminate between deposits located in the home country of the failed bank, which come first, and overseas deposits placed with foreign branches of the bank, which rank alongside ordinary creditors.

The FSA has concluded that it is not right that deposits placed with UK branches of non-EEA banks should stand lower in the pecking-order than home-state deposits: if the bank goes bust, then the UK deposits would not only have unequal treatment but, because the home state deposits cross the line first, they might leave no assets with which to pay out the late-running UK deposits who come in with the rest of the field. That's considered to be unfair to wholesale depositors and the banks that fund the Financial Services Compensation Scheme, which provides compensation to retail depositors of a failed bank (including a branch of a non-EEA bank).

So the FSA want to change the rules of the race. In a consultation paper (CP12/23), the FSA sets out its plans for UK branches of banks which are subject to discriminatory depositor preference regimes. Unless the discriminatory treatment can be alleviated, those banks will have to find a structural solution. One option is to set aside some assets which are ring-fenced for the benefit of UK deposit-holders. Another is to convert the UK branch into a subsidiary. Either of these would be a major upheaval with many ramifications beyond the improved insolvency treatment of depositors. Other possibilities include trying to persuade home countries with national depositor preference to amend their own law; seeking to persuade the FSA to adopt more proportionate rules, such as a combination of restricting branches from taking deposits from retail clients (plus some "retail-like" clients, such as municipalities), mandatory disclosure for the remaining clients and more time to implement; or implementing a "dual pay" arrangement allowing the client to claim in the home state as well as the UK.

The FSA plans to bring the new rules into effect in January 2015 and, in the meantime, would require all affected UK branches to write specifically to depositors to explain the adverse treatment which they would receive.

Why is this relevant to transaction services banks?

- Transaction services providers account for a significant share of deposits placed with UK branches of non-EEA banks. Transaction services typically involve cash management and access to clearing and settlement systems which involve large cash balances.

Contents

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- It's not just retail and it's not just cash management. The FSA is as concerned about wholesale as it is retail. Whilst interbank deposits (which, for technical reasons, are not formally regarded as "deposits" under UK regulatory law) would fall outside the ban on a current drafting of the rules, there is no certainty the FSA won't amend the definition of what constitutes a "deposit". So all businesses which receive deposits of these types, including securities services as well as cash management, are affected.
- Transaction services clients demand global reach, and London is an obvious hub location. Historically London has been seen as a convenient place to do business which has welcomed foreign banks which wish to set up a local branch.
- Many transaction services banks are based in the United States. The US has a depositor preference regime which discriminates in favour of depositors whose deposits are located in the US. (The US is not alone: other countries which have depositor preference regimes include Australia and Switzerland, though they differ in the ways they operate.)

The deadline for comments on the consultation is 11 December. That tells you something about the athleticism of the regulator, too: the rule about notifying depositors about discriminatory treatment would (if the proposals are adopted) take effect in January 2013, that is two weeks and a holiday after the consultation period closes. Even Usain can't keep up with that kind of speed.

Consultation Paper:
http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf

Clifford Chance discussion note:
https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrIGRel2crGqLnALtlyZe4xHZje66rbeGKf6zwBiE73p%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaelf&attachmentsize=1014586

Client money and clearing

As you know – admit it, this is something which excited you as much as Andy Murray winning gold in the tennis – the EU Regulation on OTC derivatives, central counterparties and trade repositories (or EMIR) made it into law in July.

EMIR has some interesting rules which affect the segregation of clients' money and assets which are put up as collateral (margin) to a CCP to support cleared transactions. These aspects of EMIR are not just about clearing of OTC derivatives – they affect the whole world of clearing, including cleared cash equities business and futures business. In summary:

- clearing members must offer their clients a choice between an "omnibus" account where the client's trades and margin are pooled with other clients', and an "individually segregated client account"
- clearing members have to explain the risks of both approaches
- where the client opts for "individual seg", then excess margin provided to the clearing member must be passed up to the CCP
- if the clearing member goes bust, the CCP is obliged (if the client wants – or, in the case of an omnibus account, all the clients want) to instigate its process for transferring the client account, including positions and margin, to a replacement clearing member
- if transfer does not happen, so that there is a close-out between CCP and failed clearing member, then any balance owed by the CCP on the client account has to be returned to the client without falling into the clearing member's hands (the "leapfrog rule").

In a new consultation paper, the FSA is working out how these requirements fit together with the UK client money and client assets regimes. In the UK, a non-bank firm which takes in client money is obliged to hold it on trust for the clients, with various peculiar consequences in the clearing world:

- cash margin sent up to a CCP remains subject to the client money trust, if it was client money in the hands of the firm; but non-cash assets are not subject to this regime
- if the firm goes bust, all client money held on trust is "pooled" so that clients share pro rata in any shortfalls; the pooled cash includes sums receivable from the CCP which are classified as client money
- but cash and non-cash margin provided to the firm under a title transfer financial collateral arrangement are not subject to any of these UK rules, although it will be subject to the EMIR requirements.

This is confusing enough for firms, their compliance officers, their clients, and everyone else, but that's how we like games to be in the UK. (It was the Brits who invented the off-side rule in football.) EMIR is going to make it even more confusing. Try and hit this spinning ball.

- The FSA has concluded that transfer of a client account by a CCP from a failed clearing member to a replacement clearing member requires a modification to the "pooling" rules, to exempt the client account from loss-sharing.
- Because firms are now obliged to offer individual seg, collective loss-sharing is a thing of the past, so firms could be allowed to offer sub-pools for different types of investment business.
- The concept of a "non-seg client", whose trades were booked to the firm's "house" account (typically in the futures business world) may have been abolished by EMIR.
- Margin which is subject to the client money trust may need a different account at the CCP from margin which was the firm's own money.
- Title transfer collateral is outside the scope of these new proposals, but firms and CCPs still have to work out how to comply with the leapfrog rule requiring surplus cash on close-out to be returned to the client without disappearing into the black hole of the bust firm's bankruptcy.

Some of this is work in progress: even the FSA's paper does not explore the title transfer collateral issues very fully. When this is put in the context of the post-Lehman legal environment, where "proprietary" cash accounts can contain client money, and firms are limited in the security interests they can allow to subsist over client money and client assets, and the FSA is going to rewrite the client assets sourcebook in 2013, you can be forgiven for thinking the game is too fast to follow.

Who is affected by the proposals, and how

For firms which are not banks, a single omnibus account for clients is no longer possible: clients have to be offered individual seg, although the firm can price differentially. Firms will have to upgrade their systems, and take a hard look at their service offerings. For the client, it may be less obvious what the advantage is of the omnibus approach. In particular, transfer of positions and margin on the firm's failure will be tougher, and pooling (and absence of leap-frog) are additional downsides.

For transaction services banks, some things can be predicted. First, clients are going to need more accounts and record-keeping services to keep track of everything. Then, with the reduced attractiveness of omnibus accounts, there is going to be liquidity pressure and a need for services which help shift cash and assets to where they are needed. Furthermore, the complexity of rules around collateral arrangements is going to have to be carefully managed to avoid unexpected legal risk.

Consultation paper:
http://www.fsa.gov.uk/static/pubs/cp/cp12-22.pdf

Official Journal version of EMIR in English:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF

Clifford Chance briefing:
https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrIGRel2crGqLnALtlyZe4xHZje66rbevCcrIlp2zMHp%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaelf&attachmentsize=225285

Bankrupt infrastructures

Valiantly aiming for a place in the legislative medals-table is the UK Treasury. They've been pondering the difficult subject of how to deal with failed financial institutions for a while: they already got medals for the Banking Act 2009 (which provides a toolkit for dealing with bust banks without instigating formal insolvency proceedings) and the Investment Bank (Special Administration) Regulations 2011 (which allow administrators to deal with client money and client assets). Now they are competing in the contest for resolution of infrastructures and other systemically important non-bank financial institutions.

There was a speed-consultation over the summer (it closed on 24 September) on how to deal with failures in this key sub-sector.

What it covers

The UK government identifies four classes of systemically important non-banks: investment firms, and parent companies of banks and investment firms; CCPs; non-CCP infrastructures; and insurers. We agree that they could all be systemically important. But they are very different and will go bust for very different reasons; and the toolkit for resolving them will need different things in it if the plans are to work.

What HMT proposes

Broadly, the proposal is to extend the scope of the Banking Act 2009 regime to non-banks. The 2009 Act gave the authorities powers, in the case of a bank, to sell the whole corporate entity lock, stock and barrel by means of a share transfer, but perhaps more significantly to carve up the business of the bank into a "good bit" to be transferred to a private purchaser, or to be held in a "bridge bank" owned for the short term by the state, and a "bad bit" to be dealt with under a modified, but more traditional, insolvency regime.

A quick recap on the 2009 Act:

- Partial property transfers are typically done over a weekend, by means of an instrument made by the Bank of England. Assets and liabilities are divided between the transferee (bridge bank or private sector purchaser) and the rump of the failed bank. The failed bank goes into a formal insolvency procedure such as administration.
- Termination clauses triggered by a business transfer do not work against the transferee bridge bank/purchaser. As against the rump entity, termination is allowed. The rump entity and group companies must continue to provide services to the transferee. For "investment banks" (mainly IT) service providers must continue providing services to an insolvent investment bank.
- When the business is split, the property transfer instrument is in general not allowed to split apart obligations from the supporting collateral, or to split up obligations which were going to be set off or netted.

The current proposals will adapt the 2009 Act approach by tweaking the objectives and implementation of these powers.

Type of non-bank	Objective	Powers	Comment
investment firms and parent companies of banks/investment firms	protection of client funds and assets; avoid disruption of financial market infrastructure	share and property transfers	protection of client money and assets is tangled up with the FSA's review of its CASS sourcebook
CCPs	continuity of clearing for financial products which did not give rise to the insolvency risk	share and property transfers, including membership agreements	Banking Act protection of netting may not work where a CCP is being split up
non-CCP infrastructures: payment systems, CSDs, exchanges and trading platforms, trade repositories	continuity of service	transfer powers; loss allocation powers; step-in rights to take over management	some infrastructures take on counterparty risk, but others do not; one size does not fit all infrastructures
insurers	ability to exit market without disruption; continuity of payments to policyholders	adjust existing insolvency legislation to suit insurance business better; transfer powers	payments and support services may be required to continue, despite insolvency

As can be seen, there is a lot to think about in these proposals. Although no completely new resolution techniques are proposed, it is not at all clear that the new-ish Banking Act powers designed for deposit-taking institutions will work appropriately for these different types of institution.

The UK Treasury is not striving alone in this game. The highly influential Committee on Payment and Settlement Systems (working with the board of IOSCO) put out a consultative report on the same subject in July. And the European Commission is also interested in the subject, and is working on a legislative proposal for issue in early 2013. That will complement their proposed legislation, already in the pipeline, on the subject of failed financial institutions generally, which is designed to roll out at EU level the kind of thing which the UK did with the Banking Act 2009.

All of this would be sensible enough, but of course banks have to think about this in numerous ways. Topmost ought to be management of counterparty risk: how you deal with everyone else is, or should be, influenced by what happens if they fail. And then, looking inwards, there is the RRP question: regulators are demanding that banks provide “living wills”, which look into a dismal future of the firm’s own potential failure, and put together a plan for dealing with it. Fair enough, but with the rules of bankruptcy changing every year it’s a bit like playing snooker on a racing yacht: it wobbles unpredictably in mid-shot, it might make you feel queasy, and it’s definitely not an Olympic sport.

HMT Consultation documents:

- Financial sector resolution: broadening the regime (PDF 472KB)
- Draft legislation for consultation (PDF 205KB)
- Explanatory notes to draft legislation (PDF 90KB)

CPSS report:
http://www.bis.org/publ/cpss103.pdf

EU draft Recovery and Resolution Directive:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:PDF

Market Developments

Payments and Cash Management

1. Democracy

Time was when banks ruled the world. Actually, such time never was. But any power vested in banks is considered suspect in the post-crisis culture. And the UK Government thinks that the UK Payments Council, which sets the strategy for UK payments, is too dominated by banks. Witness, they say, the fiasco about cheque abolition, where pressure from politicians much closer to the consumer-in-the-street led to a U-turn of policy from the UKPC. So the UKPC is to be democratised. And this isn't a little local thing of interest to the Olympic City alone: the governance of SEPA is being reshaped at the same time. The European Payments Council is subject to criticisms which look surprisingly similar to those levelled at the UKPC. Don't be surprised if those reshaping SEPA use the UK model as a template.

HMT consultation (closes 10 October): http://www.hm-treasury.gov.uk/d/setting_strategy_uk_payments190712.pdf

2. Surcharging

The cost of payment services for consumers and merchants is a constant source of debate. The European Commission was excited about it in its Green Paper on card, internet and mobile payments. Now the UK Government has weighed in with a consultation on a ban on excessive surcharging when consumers choose to pay by card. Some egregious practices by airlines and local councils have been singled out for criticism by the UK Consumers' Association called Which?, which led to the current proposal. This would, in effect, be an early adoption of article 19 of the Consumer Rights Directive (2011/83/EU), which will prohibit surcharges exceeding cost.

Consultation: Consultation on the early implementation of a ban on above cost payment surcharges

3. Basic banking

The EU Commission has published a staff working document on Member States' national measures and practices as regards access to basic payment accounts. The document is a follow-up to the Commission's recommendation of 18 July 2011 on access to a basic payment account. It provides a factual overview of the measures currently in place in Member States, as reported by the Member States, and assesses the extent to which Member States are complying with the recommendation, in particular with regard to the right to open and use an account, the features of such an account, and the associated charges.

Commission paper: http://ec.europa.eu/internal_market/finservices-retail/docs/inclusion/followup_en.pdf

4. SEPA Regulation : Guidance

The European Payments Council has issued interpretative guidance on the SEPA Regulation. They also issued a "friendly reminder" in their blog, saying: "EU Law Mandates Migration to SEPA by February 2014 in Euro Area. Recommendation is to Rely on EU Legislator (Not on Speculations Regarding the Impact of the Euro Debt Crisis on SEPA) when Planning Migration. The Time to Act is Now."

EPC Guidance: http://www.europeanpaymentscouncil.eu/knowledge_bank_detail.cfm?documents_id=580

Blog: http://www.europeanpaymentscouncil.eu/blog.cfm?blog_id=42

5. FATCA

The US-UK intergovernmental agreement on FATCA was signed in September.

UK Treasury press release: http://www.hm-treasury.gov.uk/press_82_12.htm

Clifford Chance commentary on whether FATCA is now workable for EU financial institutions:
http://www.cliffordchance.com/publicationviews/publications/2012/07/is_fatca_now_workableforeuropesfinancia.html

Securities Services

1. Clinically insane

Not our words, you understand. The European Commission has signalled a revival of interest in "Securities Law Legislation". In their Post-trading Info Letter, they say it's not just for the clinically insane: it's about who owns what, which is pretty fundamental. They explain that the draft legislation will be issued later this year, and it will cover topics such as investor empowerment, regulatory tracking of risk, and collateral. This agenda seems bigger than before, and that was already pretty wide-ranging. We also wonder whether the shift in terminology – "legislation" rather than "directive" – signals a newer, tougher approach to cutting through the obstacles that have bedevilled this proposal. The Info Letter devoted two articles out of twelve to the subject. Clinically insane? Maybe only if you ignore it.

EU Info Letter: http://ec.europa.eu/internal_market/financial-markets/docs/infoletter/2012_august_en.pdf

2. Great leap forward

The China Securities Depositary and Clearing Corporation has issued a 'Notice on Relevant Issues concerning the Account Opening and Clearing of Trust Products', which allows the opening of accounts for trust products. Local trust companies can now open securities accounts for their trust products and for their entrusted management by securities companies or fund management companies. But this does not open up the direct custody market to foreign entities yet.

CSDCC paper: Notice on Relevant Issues concerning the Account Opening and Clearing of Trust Products

Clearing

3. CFTC clearing exemption for inter-affiliate swaps

The Commodity Futures Trading Commission (CFTC) has issued a proposed rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement of the Dodd-Frank Act. The CFTC is proposing to exempt certain inter-affiliate swaps from the clearing requirement subject to certain conditions, including: centralized risk management, swap trading relationship documentation, variation margin payments, and satisfaction of reporting requirements. The proposed rules would exempt inter-affiliate swaps if one of the following four conditions is satisfied for each affiliate:

- the affiliate is located in the United States;
- the affiliate is located in a jurisdiction with a comparable and comprehensive clearing requirement;
- the affiliate is required to clear all swaps it enters into with non-affiliate counterparties; or
- the affiliate does not enter into swaps with non-affiliate counterparties.

CFTC press release: http://www.cftc.gov/PressRoom/PressReleases/pr6328-12

4. Compare and contrast

There is a significant commonality of approaches between EMIR and the Dodd-Frank Act in relation to the regulation of OTC derivatives markets, but there are also some significant differences. Clifford Chance, in conjunction with the International Swaps and Derivatives Association, has prepared a paper summarising the way in which the two regimes treat different categories of counterparty and highlighting certain other major differences between the proposed EU Regulation and the Dodd-Frank Act in relation to the trading and clearing of OTC derivatives.

Paper: http://www.cliffordchance.com/publicationviews/publications/2012/09/regulation_of_otcderivativesmarkets-.html

5. Down under

The Reserve Bank of Australia is consulting on a proposal for new Financial Stability Standards for central counterparties and securities settlement facilities. The aim is to align the Australian regime with the 2012 CPSS 'Principles for Financial Market Infrastructures'.

Consultation: Council of Financial Regulators – Supplementary Paper to the Review of Financial Market Infrastructure Regulation (July 2012)