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Transaction Services Newsletter

Feature article

Circle of confusion

A one-act play

Dramatis personae

STU BIGG-TERFEL, a banker

ØVE KEEN, an intern with the European Commission Services

Scene: A long grey corridor somewhere in Brussels

[Enter STU, wearing a sharp suit, but looking bewildered; catcalls off. Enter separately ØVE, looking eager.

STU: Excuse me, I wonder if you could help me? I think I might be lost.

OK: Of course, no problem. Where do you need to go?

STU: I heard there was a meeting on the new Securities Law Legislation, but…

OK: Excellent, I am going there myself. Let us walk together.

STU: Oh that is good news. Maybe you can explain what all the fuss is about.

OK: Well, it is very important. We are trying to build the single market, and it is a major obstacle that each country has a different view of what it means when you hold securities through an account at an intermediary like a custodian or a prime broker. So the primary purpose of the legislation is to have a uniform set of legal rules about things like whether you own anything when securities are credited to your account, and what you have to do to carry out a transfer. We are going to adopt the Geneva Convention in Europe!

[They turn left into another long faceless corridor.

STU: That all sounds worthy, but, if you will forgive me, rather dull. I thought the Geneva Convention was about prisoners of war. Perhaps I should find the meeting on MiFID instead.

OK [shocked]: Oh no! It is all about who owns what! You would not want to find that someone else is claiming the assets which you had saved for your pension, surely? But that is what can happen if in the relevant country the credit to your account does not give you ownership.

STU: Fair enough, but this is Europe, not an emerging market. We don't have that sort of problem. It all works fine, except that my pension consists of share options in my bank, which haven't been worth very much since 2008.

[At the corner they turn left again into another long, equally faceless corridor.

OK: I'm not so sure. Look at Lehmans. Look at MF Global. Do you know what happened? Innocent investors left their securities with those brokers, and they found that their assets had been rehypothecated without their knowledge. We are going to make sure that scandals like that can never happen again.

STU: Hang on a minute, that's a completely different issue. My pension fund is safe with my custodian. I don't let my custodian rehypothecate. And if I need to use a prime broker I know that their terms of business permit rehypothecation. So I don't see what the problem is.

OK: Well, excuse me, but you are a banker, yes? From London? So you would see it from a certain viewpoint. The way I see it is rather different. There is no excuse for rehypothecation. It is just a hidden way in which investment firms are raising cash to fund their activities. Things like derivatives and other proprietary business which caused the financial crisis. We do not want to ban such business, but it is morally wrong that investors' assets should be used in this way.

STU: Listen, I understand what you are saying, but I disagree. In the first place, retail investors are not going to find that

Contents

Editor

Dermot Turing
E: dermot.turing@cliffordchance.com

Transaction Services Contacts

Simon Crown
E: simon.crown@cliffordchance.com

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

Simon Gleeson
E: simon.gleeson@cliffordchance.com

Monica Sah
E: monica.sah@cliffordchance.com

Caroline Meinertz
E: caroline.meinertz@cliffordchance.com

Jeremy Walter
E: jeremy.walter@cliffordchance.com

"The European Commission has, since 2010, been working on a proposal for a Directive on securities law."

their assets disappear because of rehypothecation. What is more, in the UK we have introduced transparency rules which protect all investors, so they are not taken by surprise when rehypothecation takes place.

[They turn left once more into yet another long faceless corridor.

OK: That sounds good, and the legislation may adopt those ideas: no rehypothecation for retail investors, and transparency rules, including full disclosure to trade repositories.

STU: We haven't gone quite that far yet… But, sorry, I'm still confused. I thought this legislation was supposed to be about technical legal questions over the status of securities held in accounts. What you are talking about sounds more like investor protection, and shadow banking, not about the Geneva Convention.

OK: These are necessary measures. Investment firms are treating securities like cash. If you think a credit to a securities account is just like a credit to a bank account, then you have lost the essential difference between an asset and a liability. We must clarify all this.

STU: Look, I'm awfully sorry, I still don't see the problem. If my securities are in my account, I own them, it's that simple.

OK: Unfortunately not. There are all sorts of securities accounts which don't actually signify ownership. Look what happens if your account-provider does rehypothecate: you don't own the securities any more, but the securities might still be credited to your account. There are different rules in different countries about this.

STU: Well, if you put it that way…

OK: And that's not all. Let me tell you about some other ideas we have. *[STU fumbles desperately for his i-phone.*

OK: We are going to introduce a range of investor protection measures which enhance and improve on the Geneva Convention. For example, we are going to re-connect the investor with the issuer of securities, but making it a requirement for the account provider to deliver the self-same investor experience as if the investor were a direct shareholder, regardless of the length of the holding chain. And, we think we might extend these ideas to other asset classes, like funds and derivatives as well as securities…

[They reach another passageway heading off to the left.

OK: I think we are here now.

STU: Actually, I think my Eurostar is just about to leave. Er - it was very interesting talking to you.

OK: Enjoy your journey. Don't forget to buy some chocolate!

Editor's notes

1. The European Commission has, since 2010, been working on a proposal for a Directive on securities law. The purpose of this measure is to create a harmonised set of legal rules for Europe relating to what rights an investor has when the investor is not officially registered as a holder of securities, but holds them via an intermediary, so that the investor's interest, whatever that may be, appears only as a book-entry on the intermediary's books. Most investors would prefer the law to be both certain – in some countries it is not clear what happens, for example, if the intermediary has a shortfall of securities – and harmonised – it is unfortunate if the investor's intermediary's law says that the investor can exercise rights directly, but the issuer's law disagrees. Tidying up the technical rules is therefore highly worthwhile.
2. The Securities Law Directive has been proceeding slowly, for a combination of reasons. First is probably that the financial crisis has spawned a frenzy of law-making, and policy priorities have been directed towards G20 agenda issues such as derivatives clearing, stability of financial firms, hedge fund regulation and so forth, and technical measures have slipped down the list. But there are other objections. One is that the proposals on which the Commission consulted at the end of 2010 included a set of articles which went rather further than the technical legal points: they included enhanced custody-type duties which would have applied to all account-providers, which looked difficult to operate in practice.
3. Another objection to the 2010 proposals is that the principle behind them makes lawyers from some legal traditions uncomfortable. The seat of this discomfort is the difference between "personal" and "property" rights. Personal rights are, crudely put, obligations, like debts, which depend on the survival of the person who owes them; property rights are rights in relation to "things", which survive so long as the thing itself survives. The problem with securities held in accounts is that they are just book-entries. If the investor is going to be given property rights they must

be rights in relation to "things". It is all very well for a depositor to get a deposit because his bank makes a book-entry, because everybody (well, nearly everybody) knows that a deposit is nothing more than a credit claim – a personal obligation owed by the bank, which becomes very significantly diminished in value if the bank goes bust. By contrast, a share or a bond should not disappear if the account-provider goes bust, but if the share or bond "exists" as a "thing" simply by virtue of the account-provider's book-entry then it looks to some as if the assets are being created in the same way as cash is created through credit entries on a banker's books.

4. The debate about the existence and non-existence of securities has just received a renewal of energy. It is an open secret that the Commission has issued a new discussion paper addressed to the Member States on the proposed Securities Law "legislation", this time raising the question of regulation of rehypothecation practices. The Commission observes that investors whose securities were held by Lehman Brothers and MF Global found that those assets had been subject to rehypothecation rights and, when those firms became insolvent, the investors' entitlements had become transmuted into mere "personal" claims of greatly reduced value. So there is now a fresh angle to the Securities Law debate, namely whether re-use practices, including repo, securities lending and other title-transfer techniques, need to be regulated or even prohibited in some circumstances.
5. The Commission services are understood to be considering feedback from the Member States on this topic. Banning rehypothecation or title-transfer securities techniques would seem to be an over-reaction to the market failures experienced with the two investment firm insolvencies cited. The real risk, however, is that a backlash against the Commission's thinking builds to the point where it endangers the good and useful parts of the Securities Law Legislation – the valuable articles dealing with what the legal consequences are, in all Member States, when securities are credited to a securities account.

Feature Article

The PSD2 journey

We all know that predicting the final content of European legislative measures is a bit like taking a runaway train ride at the fairground – there are so many different ways it might go and half the ride is spent in the dark just hoping the whole thing stays on track.

In keeping with the usual European legislative process, it looks like the "PSD2 Express" will not be pulling out of the station just yet; the Commission was due to provide its report on the impact of the PSD (with accompanying proposals for reform – i.e. PSD2) to the Parliament and Council (amongst others) by 1 November 2012. But that particular train does not seem to have arrived yet. At this rate, however, it seems unlikely we will see any sign of proposals getting up steam before Q1 next year.

That said, certain topics will almost certainly be on the PSD2 agenda and, broadly, we expect the report and proposals to point towards a PSD2 with three broad aspects. The first is likely to be an expansion of the scope of PSD by including additional types of transaction and services within its perimeter, the second is likely to be some fine-tuning (or possibly revamping) of existing PSD provisions such as the definitions of certain services and exceptions to scope to improve their clarity. We think the third aspect will be some tinkering to improve harmonisation and the effectiveness of the passporting regime.

Aspect one: the widening panorama

There is a good chance that PSD2 will expand the scope of the PSD to so-called leg-in/leg-out transactions, where at least the payer's payment service provider is within the EEA. Currently, some Member States, through their implementing legislation, already apply the PSD rules to such transactions, whilst others do not, resulting in an un-harmonised approach. Consequently, the argument goes, Member States should be forced to go one way or another and, from a consumer protection perspective, it would be better to go the way of applying across the board rather than dis-applying.

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Another area of potential expansion is transactions in non-EU currencies; the argument here is that customers shouldn't be any less protected because they are transacting in US$. But there are difficulties with applying all provisions of the PSD to such transactions, particularly given that the settlement would typically occur outside European borders (and consequently, to some degree, out of the control of European payment service providers).

It is also possible that certain additional payment-related services will be considered for inclusion within the scope of regulation; the front-runner in the bid for this West Coast Mainline Service is likely to be 'overlay payment services' (e.g. services where a third-party provider makes internet payments using access to online banking platforms). It is broadly acknowledged that these sorts of service currently sit outside the PSD rail yard and the debate is whether they ought to be brought inside.

Aspect two: clearing the smoke

Criticism has been levelled at the PSD as regards its clarity in certain areas and we expect that the PSD2 review will be seen as a good opportunity for the Commission to deal with some of the PSD's more ambiguous provisions. In particular, it is quite possible that the Commission might use PSD2 to clarify the scope of existing payment services activities such as 'acquiring payment instruments' (activity 5), 'money remittance' (activity 6) and 'payments by means of any telecommunication, digital or IT device' (activity 7) which would be welcome.

As regards exemptions, there are a number of provisions in Article 3 which would benefit from guidance – in particular guidance on the limited networks exemption (paragraph (k)) would helpful for those in the semi-closed-loop cards business (such as fuel cards, retail cards, etc). Guidance on the exemption for payment transactions between PSPs (paragraph (m)) would also be useful given the doubts that have arisen as to the application of this exemption where there are chains of PSPs or banks.

Aspect three: all on the same journey

PSD2 may also seek to address areas of non-harmonisation. Some differences in implementation and interpretation were inevitable (e.g. due to different systems of law) but some in the industry take the view that there are some unnecessary divergences. For example, rules on safeguarding by non-bank payment institutions in certain jurisdictions go beyond what is required to protect customers and give rise to an unlevel playing field across Europe. PSD2 may be the method by which some of the tracks are realigned so that the journey through PSD compliance in one Member State would more closely resemble the journey in others.

A potential collision course

One hazard on the horizon for PSD2 is Section 1073 of the U.S. Dodd-Frank Reform Act. Section 1073 places a number of (largely transparency) obligations onto U.S. remitters sending funds abroad (including informing customers of all the charges down the transaction chain, etc). Careful consideration should be given to whether the requirements of Section 1073 will sit comfortably with PSD2 (and vice versa), particularly if PSD2 is expanded to leg-in/leg-out transactions. Collision courses should be identified and signals suitably set at danger early in the legislative process.

The broader picture

The PSD2 review forms part of a more general introspective underway in Europe regarding the payments market and regulatory landscape (see our November article "The European Payments Regulations Landscape - where are we headed?" for more information).

Clifford Chance briefing:
https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrlGRel2crGqLnALtlyZe0FtkwiDCVVZGDdDBItIzofp%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaelf&attachmentsize=148655

Market Developments

Hottest news of the year: a new book on the law and practice of clearing and settlement in the UK and Europe, written by Dermot Turing, a partner at Clifford Chance, has been published by Bloomsbury Professional. This new textbook is the first to cover this subject-area fully, and includes introductions to the key topics of clearing, securities settlement and payments, and features in-depth analysis of new and existing legislation, such as:

- EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR);
- Proposed EU Regulation on CSDs;
- CPSS Principles for Financial Market Infrastructures;
- Settlement Finality Directive and UK implementing regulations; and
- Part VII, UK Companies Act 1989.

For more information about how to order a copy, please click on one of the links below. A Clifford Chance discount is available via the editorial board.

Links

'Clearing and Settlement in Europe' on Bloomsbury Professional website:
http://www.bloomsburyprofessional.com/?gclid=CO3y3brIkrQCFXDLtAodnXIAWQ

Publisher's Brochure:
http://www.cliffordchance.com/publicationviews/publications/2012/11/clearing_and_settlementineurope.html

Securities services

1. Client assets

The FSA's painful overhaul of the UK client asset regime after Lehmans grinds slowly on. On 1 January 2013 a collection of minor changes to the CASS sourcebook will take effect, relating to CASS oversight and reporting, and the mandate rules. More significantly, the FSA has issued a discussion paper (CP 12/22) on reforming the client assets regime to achieve a better balance between speed and accuracy of return of clients' assets when an investment firm fails. The intention is that the FSA will issue a more detailed consultation in early 2013 when policy choices are closer to finalization.

January 2013 rule changes:
PS12/20:
http://www.fsa.gov.uk/static/pubs/policy/ps12-20.pdf

CP 12/22:
http://www.fsa.gov.uk/static/pubs/cp/cp12-22.pdf

2. CSDs and T2S

A new "compromise draft" of the proposed CSD Regulation has been made available. And the ECB has reported on progress with T2S.

CSD Regulation:
http://register.consilium.europa.eu/servlet/driver?lang=EN&ssf=DATE_DOCUMENT+DESC&fc=REGAISEN&srm=25&md=400&typ=Simple&cmsid=638&ff_COTE_DOCUMENT=15334%2F12&ff_TITRE=&ff_FT_TEXT=&ff_SOUS_COTE_MATIERE=&dd_DATE_REUNION=&single_comparator=&single_date=&from_date=&to_date=&rc=1&nr=1&page=Detail

T2S progress report:
http://www.ecb.eu/paym/t2s/about/t2sonline/html/index.en.html

Cash and payments

1. Dear Santa (a letter from the FSA)

In my stocking, please can I have certainty that my banks won't go bust. Or, if that's too difficult even for a fat guy who can squeeze down the narrowest of chimneys, please can you ensure that if a bank does go bust, UK depositors don't have to stand behind other "priority" depositors who stand to get paid out first. This is what the FSA asked Santa for, in a consultation (CP12/23): they had noted that some non-EEA banks with UK branches are subject to "depositor preference" regimes which oblige the insolvency officer to pay out home state deposits first, so that foreign deposits such as those with the UK branch rank behind. The FSA consulted on a range of measures which they propose to adopt if depositor-priority cannot be equalised across borders. The period for comment has been extended to 31 January 2013.

FSA consultation CP12/23:
http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf

2. Client money and clearing

One of the curious side-effects of introducing mandatory clearing of derivatives has been the impact on clearing members' cash obligations vis-à-vis their clients. Article 48(7) of the EMIR legislation says that, in some situations, margin money due on a client account at a CCP must be paid directly to the client of the clearing member. This has a number of ramifications, one of which was a change to the client money rules (see FSA consultation paper CP 12/22, referred to above in relation to client assets). Another is the prospect of allowing investment firms to establish mini-pools for different types of client or different types of business, so that clients share losses differently in the event of the firm's failure. 2013 looks as if it may be yet another year of upheaval as regards client money compliance.

3. e-laundering and e-gambling

The Joint Committee of the European Supervisory Authorities has published a report on the application of AML/CTF obligations to e-money issuers, agents and distributors in Europe. And the Financial Committee of the German Bundestag has a plan to amend the German Anti-Money Laundering Act (Geldwäschegesetz) so that organisers and providers of online gambling services would become subject to AML obligations.

ESAs' Report:
http://eba.europa.eu/cebs/media/Joint-Committee/JC-2012-086--E-Money-Report----December-2012.pdf

GWG Press release (German):
http://www.bundestag.de/presse/hib/2012_11/2012_500/02.html

4. UK Payments Council

The UK Payments Council has, in popular estimation, been seen as the creature of banks, given that its governing body has historically been dominated by financial sector representatives, and that it is the organisation which suggested the heresy that cheques should be phased out. An effort is under way to show a newer, caring face of payments policy-making in the UK: the autumn edition of the UKPC newsletter focuses on issues of social inclusion, what to do when you send a payment to the wrong account, disabled and elderly payment services users, using chip-and-PIN without a PIN when the customer can't memorise PINs, and so forth.

UKPC communiqué:
http://www.paymentscouncil.org.uk/communique/-/page/1584/

Clearing

1. Return to sender

When you send out Christmas cards to friends who have moved house, the UK Post Office sends them back to you marked "RTS", which stands for "return to sender". Most (if not all) of the subordinate EU legislation covering clearing of OTC derivatives and regulation of CCPs was published by ESMA and the EBA, the two regulatory bodies responsible, in September, in the form of "Regulatory Technical Standards", bringing a whole new meaning to the acronym RTS. However, the European Commission has the power to return these measures to sender – that is, refer them back to the EBA and ESMA with comments, which would delay the implementation of the clearing legislation. Some industry commentators would rather like this old form of RTS to apply, because there are several areas in which some tidying-up of the ESMA and EBA proposals – and a delay – would be welcome.

EBA Draft technical standards on capital of CCPs:
http://eba.europa.eu/cebs/media/Publications/standards/EBA-DraftRTS-2012-01--Draft-RTS-on-capital-requirements-for-CCPs--.pdf

ESMA draft technical standards:
http://www.esma.europa.eu/content/Draft-technical-standards-under-Regulation-EU-No-6482012-European-Parliament-and-Council-4-J

2. American cheeses

Cheese is something which can cause all sorts of emotions, including international insults uttered by a certain former US President. Now it seems clearing is getting cheesy. Bloomberg reported that the CFTC might postpone some of its rules relating to overseas swaps, and CFTC Commissioner Scott O'Malia had said the CFTC's rule-making process has started to "resemble Swiss cheese." But there is still plenty to chew on: the CFTC has issued rules on which CDS and IRS products need to be cleared, and on intra-group exemptions from clearing. The US Treasury has also confirmed the exemption of FX swaps and forwards from the definition of "swap" for the purposes of Dodd-Frank.

CFTC clearing determination on CDS and IRS:
Press release: http://www.cftc.gov/PressRoom/PressReleases/pr6429-12
CFTC no-action letter about swaps between affiliates:
Press release: http://www.cftc.gov/PressRoom/PressReleases/pr6430-12

3. Achtung! Minen! Crossing the border, or cross purposes?

One difficulty with the EMIR-driven clearing obligation is knowing whether the EU will recognise non-EU regimes as "equivalent" to EMIR, so that (among many other things) clearing at a non-EU CCP is sufficient to achieve EMIR compliance. As a first step in a political minefield, the EU Commission has given ESMA a formal mandate seeking its technical advice on legislation concerning the equivalence between the legal and supervisory frameworks of certain third countries and EMIR.

Formal request for technical advice:
http://www.esma.europa.eu/system/files/formal_request_for_technical_advice_on_equivalence.pdf

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