ABRIDGED VERSION

THE CITY OF LONDON LAW SOCIETY'S FINANCIAL LAW COMMITTEE

RESPONSE TO CONSULTATION DOCUMENT OF JULY 2008 ON MODERNISING THE INSOLVENCY PROTECTIONS FOR THE OPERATION OF FINANCIAL MARKETS - PROPOSALS TO REFORM PART 7 OF THE COMPANIES ACT 1989

1. The City of London Law Society (CLLS) represents approximately 12,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

2. The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, have prepared the comments below in response to the above consultation document. The members of the working party comprise:

Geoffrey Yeowart	-	Lovells LLP (Chairman of the working party and Deputy Chairman of the Financial Law Committee)
Ian Annetts	-	Allen & Overy LLP
Mark Evans	-	Travers Smith LLP
Dorothy Livingston	-	Herbert Smith LLP (Chairman of the Financial Law Committee)
Michael Raffan	-	Freshfields Bruckhaus Deringer LLP
Richard Stones	-	Lovells LLP
Dermot Turing	-	Clifford Chance LLP

3. We welcome the proposals set out in the draft Financial Markets and Insolvency Regulations 2008 (the "draft Regulations") and support the thinking set out in the Consultation Document. We have, in our response below, noted a number of additional areas where (consistent with the thinking in the Consultation Document) improvement to the law protecting financial markets and infrastructures against the risk of default by one or more participants would be highly desirable. These additional comments are not a criticism of the proposed draft Regulations. In our view, it would be sensible for the draft Regulations to be extended to cover these additional points, many of which are in our view of equal importance to the points raised in the Consultation Document. However, if this is not achievable at this stage, we would urge the Treasury to proceed with the proposals set out in the draft Regulations (subject to our other comments) rather than defer the implementation of the draft Regulations pending further consideration of our additional suggestions.

4. We have not commented in this response on the drafting of the proposed Regulations as such. Once the policy behind them has been settled, we should be glad to assist in commenting in detail on the draft Regulations.

Question 1: Do you agree that the scope of the proposed amendments, reflected in paragraph 2.5 of the consultation document, is appropriate?

5. We strongly suggest that the scope of the proposed amendments be widened to deal with the issues below.

6. First, it should be made clear that the Banking (Special Provisions) Act 2008, and any new legislation introduced following the consultation on "Financial Stability and Depositor Protection : Special Resolution Regime" ("SRR"), will not undermine the special statutory regime created to protect the financial markets by the combination of the following:

   (a) Part 7 of the Companies Act 1989 ("Part 7") and The Financial Services and Markets Act 2000 (Recognition for Investment Exchanges and Clearing Houses) Regulations 2001 (the "2001 Recognition Requirement Regulations");

   (b) The Financial Markets and Insolvency Regulations 1991 (the "1991 Regulations") and The Financial Markets and Insolvency Regulations 1996 (the "1996 Regulations");

   (c) The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"); and

   (d) The Financial Collateral Arrangements (No 2) Regulations 2003 (the "FCA Regulations");

   which are collectively referred to in this response as the "Special Statutory Regime".

7. Secondly, the other parts of the Special Statutory Regime also need to be reviewed (in conjunction with Part 7) to ensure that a coherent and consistent approach is adopted to achieving financial stability and systemic integrity, and to filling gaps in the existing protection. To give one example, it is essential that the 1996 Regulations, which extend Part 7 with modifications to "system-charges" granted in favour of settlement banks which undertake to make payments in connection with the settlement of transactions through a relevant system such as CREST, be similarly modernised and the anomalies and gaps in the existing framework previously pointed out by the CLLS be dealt with. We note (and welcome) clause 232 of the recently published Banking Bill which reserves powers to HM Treasury to make regulations about financial collateral arrangements. Similarly, care should also be taken when preparing legislation to introduce the new SRR regime (including secondary legislation and the proposed Code of Practice under the Banking

Bill) that it does not inhibit or delay the fast-track enforcement procedure available to CREST settlement banks[1].

8. Thirdly, Part 7 should be extended to protect the operation of a multilateral trading facility ("MTF") within the meaning of the Markets in Financial Instruments Directive ("MiFID"), where the operator is providing the services of the MTF from an establishment within the UK (or otherwise providing services into the UK), since an increasing volume of trading is being executed on MTFs, as opposed to a recognised investment exchange ("RIE"). An MTF is required to be operated by a RIE or by an operator which is authorised by the Financial Services Authority ("FSA") and/or the Financial Markets and Services Act 2000 ("FMSA"). In addition, an MTF is likely to use the settlement services provided by a recognised clearing house ("RCH"). If an MTF is not able to take swift and effective action in response to the default of a member (which action would be safeguarded by Part 7), this could adversely affect the integrity of the market operated by it and (potentially) the position of the RCH (or the clearing members of the RCH). The Part 7 regime already applies to RIEs and RCHs. It is logical that it also be extended to MTFs, since a significant gap will otherwise be left in the statutory protection against systemic risk for the UK's financial markets. If the operation of MTFs is not protected in the same way as RIEs and RCHs, this might potentially also have an adverse effect on competition as MTFs may come to be perceived as less robust and protected from the systemic effects of the insolvency of a participant in their markets. This would potentially defeat the aim of MiFID to increase competition between trading venues for securities and other investments.

9. Fourthly, Part 7 needs to provide protection to central counterparties ("CCPs") which incur increased risks as a result of entering into interoperable or linked arrangements with one or more other CCPs. For instance, the concept of default rules in Part 7 (and as contemplated by the 2001 Recognition Requirements Regulations) should be extended to deal with the possibility that a CCP may need to take action not only in response to the default of one or more of its own members, but also in response to another linked CCP with which it has put in place interoperable arrangements. A similar extension is required in relation to the proposed protection of contributions to the default fund of an RCH for the purposes of covering losses arising in connection with the defaults by CCPs (irrespective of whether they are also RCHs). In addition, we consider that the interoperability provisions should not be limited to interoperable arrangements only with another ***recognised*** clearing house. A recognised clearing house may wish to interoperate with (i) a recognised investment exchange which provides its own clearing services or (ii) any other body, in the UK or elsewhere, which is authorised to provide CCP clearing services. There is no UK regulatory requirement that a CCP must be an RCH. There is, of course, no current jurisdictional limitation on the application of Part 7 (which applies to recognised overseas investment exchanges and recognised overseas clearing houses). The

[1] Chapter 6, Section 7, of the CREST Reference Manual, available at www.crestco.co.uk (legal documentation appears under "resources").

provisions of section 183 of the Companies Act 1989 helpfully restrict the ability of the UK courts to assist in an overseas insolvency proceeding which is inconsistent with the principles laid down in Part 7. On this basis we believe that it would assist in ensuring the stability of UK CCPs (and of the markets served by them and other CCPs) if the interoperability provisions were extended to appropriately authorised overseas entities. We also consider that any refusal to extend the proposed Part 7 protections to interoperable arrangements with CCPs that are not RCHs (but are otherwise appropriately authorised) is potentially inconsistent with the spirit of Article 46 of MiFID.

Question 2: Do you agree that default fund contributions should be given explicit recognition under Part 7?

10. We agree that Part 7 should expressly recognise the use of default funds by central counterparties and should confer on such funds the same level of protection as currently available to margin. This protection should be made available however the fund is described in the applicable rules of the clearing house or exchange. For instance, the Clearing Rule Book of the European Multilateral Clearing Facility (EMCF) refers to a "clearing fund" while the Rules of European Central Counterparty Limited (EuroCCP) refer to a "guarantee fund". The fund should also be protected whether the contribution to the fund is made by the member itself or by its parent company or another entity. There needs to be complete legal certainty that the default fund may be used by the CCP in the way provided in the applicable rules, including making good an unsecured loss incurred by the CCP as a result of a member's (or other CCP's) default.

11. We also agree that the 1991 Regulations be amended so that a charge over a contribution to a default fund is capable of being a "market charge" in the same way as is a charge over property provided as margin in respect of market contracts.

12. The proposed amendment to paragraphs 12 and 25 of the Schedule to the 2001 Recognition Requirements Regulations will require the balance of the defaulter's contribution to the default fund to be brought into account. We agree that this is correct in principle. As a more specific point, it seems to us that the default rules of an RIE or RCH will need to determine how the default fund contributions will be allocated where the rules require separate accounting for client and "house" transactions. We suggest that the default rules should be required to include an appropriate provision, but that it be left to the RIE or RCH to decide what this provision should say.

Question 3: Do you agree that the current legislation should be amended, in line with insolvency protections available to clearing houses in several other jurisdictions, to allow central counterparties to apply the net house account surplus of a defaulting clearing member to cover any net deficit on that member's client account held at the central counterparty, before balances are returned to the defaulter?

13. We agree that the current legislation be amended to permit a CCP to apply any net surplus of a defaulter on house account against any net deficit on that member's client

account held at the CCP, before balances are returned to the defaulter. Although this may make inroads into the rights of unsecured creditors of a defaulter, we believe that this disadvantage is plainly outweighed by the benefit of minimising systemic risk.

Question 4: Do you agree that cross-margining agreements between recognised clearing houses or recognised investment exchanges and with another person, where that person is within or outside the UK, should be protected under Part 7, including the 1991 Regulations and 2001 Recognition Requirements Regulations? Is the amended wording added to section 155 suitable to cover cross margining agreements?

14. Although cross-margining arrangements are in their infancy, we agree that Part 7 should recognise that CCPs may share margin to cover the position of members common to both systems. Such arrangements offer significant benefits in terms of liquidity management and savings on the capital to be committed as margin. The scope of a "market contract" needs to be expanded to include a cross margining agreement. The definition of "margin set off agreement" also needs to be flexible enough to cover evolving forms of agreement, whether they rely on the techniques of charge, cross guarantee, set-off or otherwise. We suggest that the definition focuses on the effect of the arrangement rather than its legal form.

Question 5: Do you agree that under a cross-margining agreement, a member common to the central counterparties should be a single legal entity or should the definition of a common member in this context be extended to include other participating members of either central counterparty which are in the same group? If the latter, how would that extension work?

15. We consider that the definition of a common member for cross margining purposes should be not be limited to the same legal entity but be capable of including members of the same group of companies, where both members have opted into the arrangement. It may be necessary to underpin the arrangement by means of each participating group company guaranteeing the liabilities of the other, in order to achieve the mutuality required for netting and set-off.

Question 6: Do you agree with our proposed approach to the amendments to the definition of market contracts? Is it helpful that the Regulations do not prescribe eligible non-investment products?

16. We agree that Part 7 be extended to protect the clearing of non-investment products through a CCP's services. We are content that the proposed Regulations do not attempt to prescribe eligible non-investment products, in case the prescribed details become out of date with the passage of time.

17. We suggest that it be made clear that, where the rules of a clearing house or exchange are expressed to be incorporated into the clearing contract arising between the CCP and a member, the rules be treated to that extent as forming part of a market contract for Part 7 purposes. Although default rules are specifically protected by Part 7, other provisions of

the rules are often equally important, such as those dealing with novation, netting and loss sharing.

18. At present Part 7 protection does not extend to all obligations between a RCH and a member and we suggest that it should be amended to cover obligations not currently protected and permit the use of collateral for the purpose of satisfying them.

Question 7: Do you agree that contracts between recognised clearing houses for the purposes of parallel clearing should be captured within the definition of "market contract"? If yes, do you agree that the definition should also be extended to recognised investment exchanges, and to central counterparties providing clearing services that are not recognised under FSMA?

19. Yes, we agree on both counts.

Question 8: Do you have views on possible extensions to provisions on client money?

20. We agree that the provisions on client money should be available in cases where the member is under an obligation to segregate clients' assets under a foreign law or by agreement. However, in doing so, care should be taken not to impose obligations on CCPs without good reason. The CCP should not be required to investigate foreign law requirements as to what should be treated as client money. Instead, a CCP should be placed in broadly the same position as a bank receiving money from a customer in the sense that the CCP may rely on what it is told by the member. It should be left to the member to decide whether to establish a client account and, if so, how to allocate trades and margin between client and house accounts. The CCP should be able to rely on the choice made by the member without any duty to investigate whether the member is complying with its obligations to its own client. It should be possible for a member to choose to set up and use a client account even if it does not have a legal obligation to segregate. It is essential that legal certainty exists as to what is held on client account and what is held on house account.

Question 9: We propose amending sections 159, 161 and 163 to take into account changes in the law relating to administration so that they take account of administration on an equivalent basis to bankruptcy and winding up. This is consistent with the purpose of section 154 of Part 7, namely to safeguard the operation of a recognised investment exchange's, or recognised clearing house's, default rules. Do you agree with these changes, in particular the disapplication of the whole of paragraphs 40 and 41 of Schedule B1 to the Insolvency Act 1986 and sections 10 and 11 of the 1986 Act and the amendments to sections 159, 161 and 163 of Part 7?

21. We agree with the proposed changes and, as stated in paragraph 7 above, suggest that other regulations forming part of the Special Statutory Regime be reviewed to ensure that they are more closely and consistently linked together. For instance, it would be helpful to provide that:

(a) where an RCH or RIE receives protections under Part 7 and is also a designated system under the Settlement Finality Regulations, then (i) a market contract under

Part 7 constitutes or gives rise to a "transfer order" under the Settlement Finality Regulations, and (ii) a "market charge" under Part 7, and a "system-charge" under the 1996 Regulations held by a settlement bank in a designated system, also constitutes a "collateral security charge" under the Settlement Finality Regulations; and

(b) where a market charge, collateral security charge or system-charge is taken over financial collateral (as defined in the FCA Regulations), it also constitutes a "security financial collateral arrangement" under the FCA Regulations, whether it is taken as a fixed or floating charge[2].

22. We also suggest that the Credit Institutions (Reorganisation and Winding-up) Regulations 2004 be reviewed to ensure overall consistency with Part 7 (as amended) and other parts of the Special Statutory Regime and to identify any consequential amendments which may be necessary to the 2004 Regulations.

Further issue to consider

23. There is a further lacuna relating to set-off which appears to have been overlooked in the draft Regulations and which could be usefully removed. The Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2002, allows insurance companies to go into administration. Under article 5 of the Order, where an administration order is made in respect of an insurer and it subsequently goes into liquidation, sums due from the insurer to another party are not to be included in the account of mutual dealings rendered under Rule 4.90 of the Insolvency Rules 1986 (*mutual credit and set-off*) if, at the time they became due:

(a) an administration application had been made under paragraph 12 of Schedule B1 to the Insolvency Act 1986 in relation to the insurer;

(b) in the case of appointment of an administrator by the holder of a qualifying floating charge, a notice of appointment has been filed with the court under paragraph 18 of Schedule B1 in relation to the insurer; or

(c) in the case of appointment of an administrator by the company or its directors, a notice of intention to appoint has been filed with the court under paragraph 27 of Schedule B1 in relation to the insurer.

24. A concern arises in this context similar to that identified in paragraph 2.36 of the Consultation Document, namely that the CCP (or other person exercising default rights under Part 7) would be unable to include sums due under a closing-out contract if the defaulter which is party to the market contract is an insurer in administration. We suggest

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[2] One reason why this would be useful is that an RCH or RIE would then be able to rely on the right of use conferred by regulation 16 of the FCA Regulations to charge the margin and default fund contributions for the purpose of securing intra-day and other liquidity provided to it by an external liquidity provider.

that serious consideration be given to the possibility of repealing article 5 of the 2002 Order. It no longer serves a useful purpose as Rules 4.90 and 2.85 have been recast by the Insolvency (Amendment) Rules 2005. Repealing article 5 would be a easier drafting task than adapting the proposed new regulations to cover the 2002 Order as well as Rule 2.85.

25. We should welcome the opportunity to be consulted in relation to the next draft of the Regulations when this becomes available.

The City of London Law Society
Financial Law Committee
17 October 2008