

# **Modernising the insolvency protections for the operation of financial markets – proposals to reform Part 7 of the 1989 Companies Act**

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July 2008



HM TREASURY





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protections for the operation  
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Companies Act

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# EXECUTIVE SUMMARY

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Part 7 of the Companies Act 1989 modifies general insolvency law to provide systemic protection for certain financial markets in the event that one of their participants defaults. Due to the rapidly evolving nature of financial markets, the Act allows for these provisions to be updated by regulations and this consultation concerns proposals for such an update.

Central counterparty clearing, which is the main focus of Part 7, is increasingly recognised as a vital element of market infrastructure, helping to guarantee transactions and produce efficiencies of risk management. In November 2004 the IOSCO (International Organization of Securities Commissions) and the Group of Ten central banks produced recommendations for the operation of central counterparties. The amendments proposed here are in accord with those recommendations, and with the recent proposal by the EU Commission to update the Settlement Finality Directive in line with latest market and regulatory developments, including the increased interoperability of systems.

Central counterparty clearing addresses the risk of counterparty default in market transactions: the rules of the clearing house or exchange provide that the central counterparty is interposed in market transactions, becoming the buyer to every clearing member seller, and the seller to every clearing member buyer. Central counterparties' procedures include calculating, at least once per day, the risk that each member's business poses to the clearing house, and requiring each member to put up collateral to cover its position. As a second line of defence, members may also be required to contribute to a pooled default fund, for use in the event that any individual member's cover for margin in default proves insufficient.

A market development specific to central counterparties is the advent of cross-margining agreements between central counterparties who have a common member. Again, this promotes efficiency because the agreements allow a member's exposure across different markets in which he operates to be aggregated for the purpose of calculating his margin requirements.

The proposed legislative amendments accordingly cover an expansion of the definition of market contracts, and specific provision for the operation of default funds and cross-margining arrangements. They also address more minor technical issues to do with 'client accounts', to ensure that, where appropriate, 'client monies' provisions of other jurisdictions are honoured and that exchanges or clearing houses are able to use excesses on members' house accounts where there is a deficit on the members' client account.

Draft regulations are set out at Annex A and an initial impact assessment on the costs and benefits is included at Annex B. Comments are invited on the proposals set out in this document, either generally or in response to the specific questions posed. The deadline for responses is 16 October 2008.



# INTRODUCTION

**What does Part 7 do?** **1.1** The regime in Part 7 of the Companies Act 1989<sup>1</sup> and accompanying secondary legislation (namely the Financial Markets and Insolvency Regulations 1991 (“the 1991 Regulations”) and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (“the 2001 Recognition Requirements Regulations”)) is designed to safeguard the operation of financial markets. It does this by modifying insolvency law to protect the actions of recognised clearing houses and recognised investment exchanges<sup>2</sup> in the event that one of their members defaults on the obligations he has entered into in the course of buying or selling financial instruments.

**1.2** The protections given to recognised clearing houses and exchanges enable them to take action to close out a defaulter’s unsettled market contracts in accordance with their default rules. This may include offsetting profits and losses on different contracts and setting off assets provided as margin against net losses. The liquidator for the defaulter is prevented from unpicking these transactions. The term recognised clearing house and recognised investment exchange includes an exchange or clearing house recognised by the FSA which is based overseas.

**1.3** These protections safeguard the integrity of financial markets, and public confidence in them, by minimising the disruption caused by the default of the member of a clearing house or the member of an exchange. They are designed to try and ensure that the market is immunised against repercussive effects from an individual insolvency or default, and ultimately against systemic failure.

**1.4** Clearing houses (see footnote 2) that are central counterparties or exchanges that run in-house clearing arrangements manage the risk that clearing member counterparties to market trades will become unable to fulfil their obligations when they become due. The rules of the exchange and/or the clearing house specify that, by novation or an equivalent formality, the central counterparty becomes contractual intermediary – buying from the seller and selling to the buyer, so that performance of the contract is guaranteed, subject of course to the viability of the central counterparty itself. The operation of their default rules is central to their ability to manage the risks that they assume. To the extent that they were unable to enforce their default rules, the benefits and economic efficiency of their role in the market would be compromised.

**Why does Part 7 require reform?** **1.5** Since 1989 there have been significant developments in the scale and nature of the operations of the markets from which Part 7 offers protection. In 1989 the principal central counterparty clearing business in the UK involved futures and options traded on the London International Financial Futures Exchange (LIFFE), the London Metal Exchange (LME), and the International Petroleum Exchange (IPE; now ICE Futures

<sup>1</sup> For the purposes of this paper, references to the “Part 7 regime” are taken to include not only Part 7 of the Companies Act 1989 but also secondary legislation made under powers in Part 7, including the Financial Markets and Insolvency Regulations 1991 (SI 1991/880) and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995) which include provisions previously contained in Schedule 21 to the 1989 Act.

<sup>2</sup> The UK has the following Recognised Investment Exchanges: EDX London Ltd, ICE Futures Europe, LIFFE Administration and Management, London Stock Exchange plc, PLUS Markets plc, the London Metal Exchange Ltd, and SWX Europe Limited. The UK has the following Recognised Clearing Houses: Euroclear UK & Ireland Ltd, LCH.Clearnet Ltd, ICE Clear Europe Ltd and the European Central Counterparty Ltd. The UK has the following Recognised Overseas Investment Exchanges: Cantor Financial Futures Exchange (CFEE), Chicago Board of Trade (CBOT), Eurex (Zurich), ICE Futures US Inc, National Association of Securities Dealers Automated Quotations (NASDAQ), New York Mercantile Exchange (NYMEX) Inc, NQLX LLC, RMX Risk Management Exchange, Sydney Futures Exchange Limited (SFE), The Chicago Mercantile Exchange (CME), The Swiss Stock Exchange (SWX), US Futures Exchange LLC. The UK has the following Recognised Overseas Clearing Houses: SIS x-clear AG, Eurex Clearing AG, The Chicago Mercantile Exchange (CME), ICE Clear US Limited.

Europe Ltd). Volumes on each of these markets has risen substantially since then, and now central counterparty clearing undertaken by LCH.Clearnet Ltd has expanded to include cash equity business, including trades on the London Stock Exchange's SETS (Stock Exchange Electronic Trading Service) platform, and over-the-counter (OTC) interest-rate swap markets, US energy contracts traded on the Intercontinental Exchange, plus large volumes and values of trades in European bonds, and repurchase agreements (repos) traded electronically or OTC.

**1.6** There have also been important developments in the organisation of central counterparties since 1989. For example, many central counterparties now have established funds, based on members' contributions, to offer additional protection (beyond margin) to the central counterparty in the event of default.

**1.7** The proposals in this consultation document are part of an on-going process of keeping Part 7 up to date. The need to update Part 7 periodically was anticipated by the inclusion in Part 7 of significant powers to revise the legislation by statutory instrument. These powers are vested in the Treasury and in some cases jointly with the Treasury and the Department for Business, Enterprise and Regulatory Reform (BERR) reflecting the position that this piece of legislation is part of the corpus of company law for which BERR is responsible, but that it impacts most significantly on financial services legislation for which the Treasury is responsible.

**1.8** The Treasury, Bank of England and the FSA are also consulting about a wider set of reforms to the arrangements for dealing with failing banks and building societies. A consultation document is available on the Treasury website.

## HOW TO RESPOND

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**1.9** The consultation period will begin on **24 July** and will run for 12 weeks until **16 October**. Please ensure that your response reaches us by that date. Please send responses to this consultation document to:

Hannah Gurga  
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**1.10** When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents, and where applicable, how the views of members were assembled.

## CONFIDENTIALITY

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**1.11** All written responses may be made public on HM Treasury's website unless the author specifically requests otherwise in writing.

**1.12** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regime. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligation of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

**1.13** In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response.

**1.14** Subject to the previous three paragraphs, if you wish part (but not all) of your response to remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and another confidential version for use by HM Treasury.

**1.15** A Summary of Responses will be published at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

**1.16** Any FOIA queries should be directed at:

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## CONSULTATION QUESTIONS

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**1.17** Comments are welcome on all aspects of this proposal. We have posed nine specific questions, which are as follows:

1. Do you agree that the scope of the proposed amendments, reflected in paragraph 2.5 of the consultation, is appropriate?
2. Do you agree that default fund contributions should be given explicit recognition under Part 7?

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?
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?
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?
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?
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?
8. Do you have views on possible extensions to provisions on client money?
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 the 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?

**1.17** Looking ahead, we expect the nature of clearing and settlement operations will continue to develop as a result of market innovation as well as EU initiatives (for example, initiatives aimed at promoting greater interoperability between central counterparties) or otherwise. Although beyond the scope of the current consultation, such developments may necessitate further updating of Part 7. We would therefore be interested in views on the areas where market development may potentially lead to further changes of Part 7, and what these changes might be.

## Impact Assessment

**1.18** HM Treasury has prepared an initial impact assessment of the costs and benefits of the proposed amendments. This is set out in Annex B. We would welcome

any comments on our views, and will publish a revised impact assessment alongside a Summary of Responses following consultation.



# 2

## THE ISSUES THAT REQUIRE REFORM OF PART 7

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**2.1** This chapter sets out the scope of the proposed changes to the Part 7 regime and the issues that these changes are designed to address.

### AMENDING THE INSOLVENCY REGIME FOR CENTRAL COUNTERPARTY CLEARING ACTIVITY

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**2.2** The Part 7 regime dates from 1989, and has not been comprehensively over-hauled since then. Although piecemeal changes have been made at various times, it has not kept up with market developments, in particular the extension of central counterparty clearing activity.

**2.3** The market efficiency benefits of central counterparty clearing activity have been widely recognised by the public and private sectors alike; as have the potential systemic risk implications if the risk controls operated by central counterparties were found wanting. Legal risk is one of the sources of potential weakness in those risk controls.<sup>3</sup>

**2.4** Updating Part 7 to reflect change will minimise the residual legal risks run by central counterparties providing clearing services in the UK. Part 7 modifies the general law of insolvency and in this respect may affect the rights of general creditors of parties to market contracts. However, the proposed amendments will better enable recognised clearing houses and recognised investment exchanges to manage a default, thereby reducing the risk of market instability.

**2.5** The Government wishes to consult on six sets of changes to the Part 7 regime. The changes relate to:

- default fund arrangements;
- the use of house account surpluses to meet deficits on client accounts;
- cross-margining agreements between recognised clearing houses and recognised investment exchanges and other persons with members providing collateral;
- the definition of a “market contract”;
- client money;
- the need to reflect certain amendments to the law of administration.

**QI** Do you agree that the scope of the proposed amendments, reflected in paragraph 2.5 of the consultation, is appropriate?

### DEFAULT FUND ARRANGEMENTS

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<sup>3</sup> see CPSS-IOSCO (Committee on Payment and Settlement Systems – International Organization of Securities Commissions) Recommendations for Central Counterparties, November 2004, Rec.12.

**2.6** The primary protection that central counterparties have, in the event of default of a clearing member, is the margin that the defaulting member put up as part of doing business through the central counterparty. Initial margin requirements are calculated by the central counterparty to reflect the risk inherent in the open contracts of each of its members. Initial margin requirements are re-calculated at least once every day, and there are additional calls to flatten valuation changes (variation margin) that also occur at least once each day.

**2.7** In the event of default of a member, the open contracts a central counterparty has with the defaulting member would be closed out and margin applied to meet any losses. But additional resources are required to address the contingency that losses exceed margin.

**2.8** Over the last decade, European central counterparties, starting with LCH<sup>4</sup> in 1996, have increasingly followed a longer-established practice in the United States and set up default funds as a standard part of their protections against the possibility of a member defaulting and incurring losses over and above the margin that it has provided. Contributions are generally based on each member's relative level of business with the central counterparty and are re-calculated less frequently than for margin. In the event of a member's default, the central counterparty would first utilise that member's margin and its contribution to the default fund to off set any losses. If this proved insufficient, the central counterparty would then at a later stage have recourse to the remaining default fund, which would include contributions from other non-defaulting members.

**2.9** Default funds are now considered a core risk control in central counterparty clearing arrangements<sup>5</sup> and are accepted market practice. However, there is currently no explicit mention of default fund arrangements in Part 7. It refers only to 'margin' and 'cover for margin' as UK clearing houses did not have default funds in 1989, at the time of the original legislation, nor at the time of the updating contained in the 1991 Regulations. 'Margin' and 'cover for margin' may be construed as sufficiently broad to encompass default fund arrangements - margin and default fund contributions serve similar economic functions, providing protection to the clearing organisation in relation to the risks posed by the possibility of a member's default. However, margin can only be used to offset the losses of the defaulting member providing the margin whereas default fund contributions may be used to offset the losses arising from the default of a member other than the one providing the contributions. Relying on such a broad construction therefore leaves some uncertainty for central counterparties.

**2.10** Making explicit reference to default funds in Part 7 will remove any such uncertainty. Certainty of access to such funds is essential if clearing houses are successfully to contain systemic risk in the case of member failure in volatile market conditions. Part 7 modifies the general law of insolvency and in this respect may affect the rights of general creditors of parties to market contracts. However, the protections afforded by Part 7 serve the public interest as the arrangements it protects are those which provide central counterparties with a credible means of handling a default, thereby reducing the risk of market instability. Any inability of a UK central counterparty clearing house to contain the failure of a member or members, because it was denied access to its default fund by legal action, could severely damage the

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<sup>4</sup> now LCH.Clearnet Ltd.

<sup>5</sup> see CPSS-IOSCO *op cit*, Rec.5.

reputation of London as a financial centre, and of the UK's supervisory and regulatory framework.

**2.11** We propose to amend Part 7 to provide explicit recognition of default fund contributions. This will also entail consequential amendments to the Financial Markets and Insolvency Regulations 1991 so that a market charge can be applied to a default fund contribution as well as cover for margin.

**Q2** Do you agree that default fund contributions should be given explicit recognition under Part 7?

## USE OF HOUSE ACCOUNT SURPLUSES TO MEET DEFICITS ON CLIENT ACCOUNTS

**2.12** Under arrangements in the UK, clearing members have two types of margin accounts with central counterparties: house accounts and client accounts. The business allocated to each account by clearing members is separately margined by the central counterparty.<sup>6</sup> House accounts relate to contracts that arise from proprietary trades, or from trading on behalf of clients who have not opted to have their accounts segregated from those of their broker or other intermediary who is a clearing member of the central counterparty. The central counterparty has no contractual relationship with any clients of its clearing members. Client accounts are clearing members' accounts at the central counterparty that relate to business undertaken by clearing members in respect of clients who have opted under general conduct of business rules to have their accounts segregated from those of the firm.

**2.13** In the event of a member defaulting, central counterparties are currently prevented from using any surplus on margin after closing out contracts on the house account to offset any deficit on margin after closing out contracts on the segregated client account. This does not take into account the fact that clearing houses contract with their members on a principal-to-principal basis, are not formally subject to the client money rules, and that certain clients may formally opt out of segregation under long-established provisions of London market practice.

**2.14** The effect of this provision in the 1989 regime is two-fold. First, it treats the interests of segregated and non-segregated clients in relation to any balances due from a central counterparty in the event of default of their broker who is a clearing member of the central counterparty in the same manner. Second, the clearing house is more likely to become an unsecured creditor in respect of the estate or property of the defaulter, because of a rule concerning clients of a defaulting member which is not relevant to the clearing house.

**2.15** Further, if a central counterparty is unable to use a surplus on the house account, it has to meet the shortfall on the client account using other resources – the default fund and its own capital. In turn this could mean that it needed to make a call to replenish such funds. A call for additional funds at such a time could exacerbate any liquidity problems in the market.

<sup>6</sup> UK clearing houses agreed to make house and client margin accounts available to members under the *Financial Services Act 1986* (FSA 1986) so that the members could meet their obligations in respect of client monies.

**2.16** We propose 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 (if any) are returned to the defaulter. This would mean there is less available in the estate of the defaulter for unsecured creditors; however, given the importance of central counterparty clearing in the UK, and the international nature of financial markets, we believe such protection is appropriate. It is consistent with and mirrors the insolvency protections available in other jurisdictions,<sup>7</sup> including the US, where clearing houses are not prohibited from using house account surpluses to meet client account deficits. But to be clear, there is no suggestion that a surplus on a client account would be used to meet the losses on a house account.

**2.17** The amendments recognise the context of the clearing house's legal relationships, and its central role in market stability. They maintain complete separation of a defaulting member's (segregated) client account business.

**2.18** If as a result of the amendment non-segregated clients of clearing members are sensitive to an increased potential exposure in the event that their clearing member should fail and be declared a defaulter by the clearing house, they have two clear courses of action. First, they can review the financial strength of their clearing firm – to whom their exposures are likely to extend well beyond any net margin that may be held by the clearing house – and elect to move their business. Second, they can opt for segregation in which case their clearing firm will use its client account at the clearing house rather than the house account.

**2.19** It should be noted that member defaults are rare. The UK's main central counterparty clearing house, LCH.Clearnet Ltd, has handled four defaults since 1990. And in those defaults client accounts have been in significant net surplus after LCH.Clearnet Ltd has successfully closed and transferred positions and prevented market instability and contagious failures.

**Q3** 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?

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## CROSS-MARGINING

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**2.20** In recent years, central counterparties have developed legal arrangements that allow them to cross-margin the positions of members they have in common. Cross-margining, or margin offset, agreements enable central counterparties to take into account the aggregate position of a common member across their organisations when calculating margin.

**2.21** For these arrangements not to reduce risk protections in the event of clearing member default, the clearing houses and exchanges commit contractually to follow agreed 'margin sharing' protocols. In the event of default by a common member, it is either permitted or required under such agreements that a payment will be made

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<sup>7</sup> For example in 1996, Singapore revised its arrangements in line with our current proposals as a response to the failure of Barings Bank.

between central counterparty clearing organisations. The organisation making the payment will use surplus margin left after the closing out of open positions of the defaulter, in conformity with the agreement it has entered into with the other central counterparty and the common member.

**2.22** Cross-margining agreements can bring significant benefits for the members of central counterparty clearing organisations by providing savings on capital to be posted as margin. Members and their clients benefit from such inter-clearing house arrangements. Such links between central counterparties are well known and may grow further as their members seek greater efficiencies in cross-border business whether within the EU or outside.

**2.23** As with default fund contributions, it may be arguable that the operation of cross-margining agreements can be considered within scope of Part 7 through the protection for the use of margin and cover for margin. However, at present the 1991 Regulations and 2001 Recognition Requirement Regulations do not explicitly recognise payments made by central counterparty clearing organisations under cross-margining agreements. This gives rise to uncertainty similar to that referred to in the case of default funds. In addition, the existing wording of Part 7 only covers contracts that are directly cleared by the central counterparty. By definition cross-margining/margin offset arrangements involve contracts that are not directly cleared. We think it important that cross-margin agreements should be covered by the concept of a market contract since in the event of default of a common member subject to such an agreement the relevant exchange or clearing house would be under an obligation to pay margin covered by the agreement.

**2.24** Explicit reference to the way in which cross-margining agreements operate would provide clarity and greater certainty. Explicit recognition of cross-margining agreements will provide certainty around the arrangements of clearing houses covered by Part 7. We therefore propose to include the legal agreements on cross-margining between central counterparties (either recognised clearing houses or recognised investment exchanges) in the Part 7 regime. However, the draft Regulations restrict the definition of a common member under such cross-margining agreements to a member that is a single legal entity common to both central counterparties. This would exclude those members that have entered into these agreements under a group structure e.g. with an affiliate.

**Q4** 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?

**Q5** 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?

## MARKET CONTRACT DEFINITION

**2.25** Part 7 protections apply in relation to “market contracts”. Part of the definition of such contracts is that they include contracts entered into for “... enabling... rights

and liabilities... under transactions in investments to be settled.” This part of the definition dates from the Financial Markets and Insolvency Regulations 1998.

**2.26** Regulation 7 of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001<sup>8</sup> makes clear that the activity of clearing houses and exchanges is not to be limited to transactions in investments. But because of the definition above, the protections of Part 7 only apply to transactions in investments. Investments are the list of financial instruments covered by the Financial Services and Markets Act 2000. The fact that transactions in non-investments are not covered by Part 7 discourages the provision of central counterparty clearing services for such products. By acting as central counterparty for such products without Part 7 protection, an exchange or clearing house could bring into question the robustness of its overall central counterparty clearing activities.

**2.27** The Government is therefore proposing that Part 7 protections should be extended to the clearing of non-investment products. As a consequential amendment, we are also updating Regulation 16 of the Financial Markets and Insolvency Regulations 1991 so that it is aligned with the revised definition of market contract we have proposed for Part 7. We would expect this to lead to some expansion of central counterparty clearing services into areas where financial intermediaries are already active participants. We do not intend the regulations to define eligible non-investment products as such a list could become out of date quite rapidly and potentially stifle market innovation. We expect the FSA would consider such matters as part of its usual ongoing supervision.

**2.28** The current definition of a market contract also refers to contracts being entered into to enable a member’s rights and liabilities to be settled. That is clearly part of the purpose for entering into such contracts, but it does not capture the wider purpose in relation to the assumption and management of counterparty risk by central counterparties. Part 7 ought to explicitly recognise the wider purpose for entering into such contracts. A failure to do so would perpetuate a lack of clarity about the scope of market contracts.

**2.29** In addition, the existing Part 7 definition of a market contract refers only to contracts between a recognised clearing house and its members. This does not reflect recent initiatives designed to improve interoperability and increase competition in clearing services. For some exchanges, clearing members are now able to choose between two (or possibly more) clearing houses to clear their trades. In a situation where clearing members choose different clearing houses in respect of the same trade, a contract between the two clearing houses is necessary to complete the transaction chain. This contract mirrors the ‘market contracts’ between each clearing house and its member for each leg of the trade, but is not considered a ‘market contract’ for the purposes of Part 7. We think there is a strong argument that contracts of this type should be included within Part 7 on grounds of financial stability. The EU Commission has also recently set out proposals to amend the Settlement Finality Directive so that its protections extend to settlement between linked systems. This is on the basis that settlement systems are expected to become increasingly interoperable, and ensuring their proper functioning is essential for the stability of financial markets.

**2.30** We therefore propose to extend the definition of market contract so that it applies to contracts between recognised clearing houses pursuant to a parallel clearing

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<sup>8</sup> SI 2001/995.

structure. Although the amendment will have the effect of modifying insolvency law as regards the clearing house itself, this is already happening on an ad hoc basis as clearing houses are becoming members of one another to facilitate interoperability.

**Q6** Do you agree with our proposed approach to the amendments to the definition of market contracts? Are you content that the Regulations do not prescribe eligible non-investment products?

**Q7** 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?

## CLIENT MONEY

**2.31** Section 187 of Part 7 provides for the distinction between house and client accounts managed by members of central counterparty clearing organisations. Contracts related to proprietary trading can be regarded as being separate from those entered into with clients who want their resources held separately from that of the intermediary through whom they are dealing.

**2.32** Regulation 16 of the Financial Markets and Insolvency Regulations 1991 sets out the circumstances in which a member is to be treated as acting in these different capacities. It sets two conditions. These are that the market contract is:

- a relevant investment (as defined in the regulation); and
- one in relation to which money has been received by the member in accordance with the Financial Services (Client Money) Regulations 1991.

**2.33** The reference to the UK client money regulations – the Financial Services (Client Money) Regulations 1991 - is out of date. We have revised the reference. In discussion with stakeholders suggestions have been made to extend the treatment of client money to include treatment under foreign rules or to include money which a firm has agreed to treat as client money and has notified to a clearing house or investment exchange. Consultees are invited to provide their views on appropriate extensions to provisions on client money.

**2.34** It is appropriate for the definition of a market contract in regulation 16 to be aligned with that in the main body of Part 7. The draft revisions include sundry other minor updates, similarly required to reflect developments since 1991.

**Q8** Do you have views on possible extensions to provisions on client money?

## THE NEED TO REFLECT CERTAIN AMENDMENTS TO THE LAW OF ADMINISTRATION

**2.35** Certain sections in Part 7 of the Act have been amended to reflect changes introduced by the Enterprise Act 2002 e.g. section 158, which provides for certain modifications to the law of insolvency, and 175, which specifically disapplies the moratorium against the enforcement which would otherwise occur in administration in

the case of "market charges". However, there have been no comparable amendments to those provisions which would be relevant to administration in sections 159 (proceedings of exchange or clearing house take precedence over insolvency procedures), 161 (supplementary provisions as to default proceedings) and 163 (net sum payable on completion of default proceedings).

**2.36** Unless sections 159, 161 and 163 of the Act are amended to take account of administration on an equivalent basis to bankruptcy and winding up, the central counterparty would run the risk that any debts due in relation to any valid closing out contracts entered into after the onset of administration could not be taken into account in a set-off under Rule 2.85 (mutual credit and set-off) of the Insolvency Rules 1986. Rule 2.85 provides a mandatory set-off provision that applies in the context of a company's administration. Before the amendments made to the Insolvency Act 1986 as a result of the Enterprise Act 2002, it was not possible for an administrator to make distributions of assets to creditors as it now is.

**2.37** We propose that sections 159, 161 and 163 of the Act should be amended to deal with the effect of Rule 2.85. Without such amendments, an administrator might challenge the effectiveness of the default rules of a recognised investment exchange or recognised clearing house. It is clear that any debts arising under such closing out contracts could not be taken into account in the set-off under Rule 2.85. Furthermore, there is no provision in Part 7 requiring the net sum calculated to be taken into account in a set-off under Rule 2.85. This position undermines the policy behind Part 7 which already deals with the effect of an administration in many areas and should therefore also protect the operation of the default rules of a recognised clearing house or recognised investment exchange in the context of a member in administration. In section 161(4) we extend the disapplication of certain provision of the administration procedure to ensure that actions of a recognised investment exchange or recognised clearing house with regard to a defaulter under its default rules are not impeded.

**Q9** 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 the 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?

# 3

## THE DRAFTING APPROACH TO TACKLING THE REFORM OF PART 7

**3.1** Amendments are principally required to Part 7 of the Companies Act 1989 (the “Act”), but also to two pieces of secondary legislation: the Financial Markets and Insolvency Regulations 1991, S.I. 1991/880 (the “1991 Regulations”), and the Financial Services and Markets Act 2000, S.I. 2001/995 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (the “2001 Regulations”).

**Default fund 3.2** In the draft regulations we seek to ensure that insolvency law treats default fund arrangements on a par with contributions for margin so that general provisions of insolvency law are similarly dis-applied for default fund arrangements.

**3.3** To achieve this, first we have created a definition for default fund contribution. Section 188 of the Act defines the meaning of “default rules” and related expressions. The new draft regulation 2(15) inserts a definition for “default fund contribution”. The definition attempts to capture key elements of what constitutes a default fund contribution without being prescriptive in a way which would unhelpfully constrain central counterparty clearing houses in managing such arrangements.

**3.4** Second, we need to provide that the general provisions of insolvency law are disapplied to what we define as default fund contributions. Broadly, we want to ensure that collateral held by the central counterparty, whether as margin or as default fund contribution cannot be accessed by others until the central counterparty has closed out all of the defaulter’s contracts and offset any net loss. Paragraphs (2), (8), (9), (13) and (14) of draft regulation 2 ensure that this term is applied alongside references to “margin” and “cover for margin”. Then, paragraphs (8), (9) and (14) of draft regulation 2 consequently amend sections 164 (Disclaimer of property, rescission of contracts, &c), 165 (Adjustment of prior transactions) and 180 (Proceedings against market property by unsecured creditors). Paragraph (13) of draft regulation 2 inserts references to default fund contribution into section 177 to protect the application of default fund contribution from being affected by other interests consistent with the current provisions applicable to margin.

**3.5** Third, we want to ensure that a market charge can be applicable to the default fund contribution as well as cover for margin. Paragraphs (4) and (5) of draft regulation 3 amend regulations 10 and 11 of the 1991 Regulations to achieve this.

**3.6** We also want to ensure that set off does not operate to undermine the default fund arrangements. Draft regulation 4(3)(a)(iv) substitutes paragraph 12(2)(c) of the Schedule to the 2001 Regulations with new set off and aggregation provisions which ensure that the default rules of recognised investment exchanges enshrine similar rights and protections in relation to default fund contribution as apply to cover for margin. Draft regulation 4(3)(e)(iii) similarly substitutes paragraph 25(1)(c) of the Schedule with new provisions which refer to the default rules of recognised clearing houses. Draft regulation 4(3)(b) inserts a new paragraph 12A into the Schedule. This requires that the default rules of recognised investment exchanges provide that in the event of default, the default fund contribution of the defaulter is only to be used in accordance with the new set off and aggregation provisions. Draft regulation 4(3)(f) inserts a new paragraph 25A in the Schedule to include the same requirement in respect of the default rules of recognised clearing houses.

**3.7** Finally, we have inserted the relevant cross references of the definition we have added to the Act to other relevant legislation. Draft regulation 2(16) inserts a cross-

reference into section 191 of the Act – the “index of defined expressions”. Draft regulation 3(3) inserts a cross-reference into regulation 7 of the 1991 Regulations. Draft regulation 4(2) inserts a cross-reference to this definition, and a definition of “default fund”, into regulation 3(1) of the 2001 Regulations.

**House account surplus** **3.8** The drafting to deal with the issue of the use of a house account surplus is relatively straightforward. Section 187 of the Act establishes the principle that where a member of an exchange or clearing house transacts in different capacities, the transactions may be treated as being by different persons for the purposes of applying default netting under Part 7. In view of regulation 16(2) of the 1991 Regulations, where a member effects contracts within regulation 16(1) (broadly where money received is client money) such transactions qualify for separate consideration in accordance with section 187 of the Act. This principle is left unchanged by draft regulation 3(6).

**3.9** The specific prohibition on the use of a house account surplus to meet a deficit on a client account had been incorporated in paragraphs 15(1) and 28(1) of the Schedule to the 2001 Regulations in relation to investment exchanges and clearing houses respectively. The revised language in draft regulation 4 makes it clear that exchanges and clearing houses acting as central counterparty may use a defaulter’s house account surplus to meet a deficit on his client account (see draft regulation 4(3)(c) and (g) for exchanges and clearing houses respectively).

**3.10** A definition of “client account” is inserted into paragraphs 15 and 28 of the Schedule to the 2001 Regulations by draft regulation 4(3)(d) and (h) (for exchanges and clearing houses respectively). This refers in each case to regulation 16(1) of the 1991 Regulations, as amended by draft regulation 3(6).

**Cross margining agreement** **3.11** The approach to dealing with the issue posed by cross-margining agreements has been threefold:

- To cover such agreements as market contracts;
- The definition of a cross-margining agreement for investment exchanges and clearing houses respectively in draft regulation 4(3)(a)(v) and (e)(iv) (inserted into paragraphs 12 and 25 of the Schedule to the 2001 Regulations) has been added and attempts to capture the economic role played by such agreements. This approach seeks to provide a definition which does not restrict the exact form of such agreements; and
- Amounts payable as part of cross-margining agreements between clearing houses are encompassed within the default rules of such bodies (draft regulation 4(3)(a)(iii) and (e)(ii) respectively).

**Market contracts** **3.12** Paragraph (3) of draft regulation 2 amends the definition of market contracts for the purposes of Part 7. The changes deal with the two issues set out above namely:

- the failure of the current definition to explicitly encompass the activities of central counterparties; and
- the need to broaden the range of transactions to which market contracts can relate.

**3.13** On the first point, the draft Regulations amend section 155 of Part 7 so that market contracts refer not just to contracts entered into to enable the rights and liabilities of a member in respect of transactions to be settled. Section 155 as amended also explicitly includes contracts entered into by a clearing house or exchange where it becomes the counterparty to both the buyer and seller in a transaction.

**3.14** The change to broaden the range of transactions by the re-draft of section 155(2)(b) and (3)(a) to which market contracts can relate has been done in a general way so that it is not limited to investments and, for example, now covers a broad range of commodity (including emission allowances) and FX transactions.

**3.15** Following from this, when draft regulation 3(6) comes to address the definition of a relevant transaction in Regulation 16(1) of the 1991 Regulations, rather than restrict the definition to a sub-set of market contracts, reference has simply been made to the (revised) definition of a market contract in section 155 of the Act.

**Client Money 3.16** Changes to the 1991 Regulations have been covered above in respect of default funds (paragraph 3.2) and market contracts (paragraph 3.12).

**3.17** The reference to the UK client money regulations in the 1991 Regulations is to be updated to reflect the Financial Services and Markets Act 2000 (draft regulation 3(6)(a)).

**Administration 3.18** To ensure our approach applies to all insolvency proceedings, we have also made some amendments relating to administration. Section 159 of the Act sets out the types of insolvency procedure which are overridden to the extent that they are incompatible with the default proceedings of a recognised clearing house or recognised investment exchange. Draft regulation 2(5) amends this section so that it also covers the distribution of assets on an administration.

**3.19** Draft regulation 2(6) amends section 161 (supplementary provisions as to default proceedings) so that the restriction on the declaration or payment of a dividend to creditors or on the return of any capital to contributories also applies to administrators.

**3.20** Draft regulation 2(7) of draft regulation 2 amends section 163 (net sum payable on completion of default proceedings) so that it applies to administration orders as well as bankruptcy and winding up orders.



2008 No.

## FINANCIAL SERVICES AND MARKETS

## Financial Markets and Insolvency Regulations 2008

<i>Made</i>	- - - -	2008
<i>Laid before Parliament</i>		2008
<i>Coming into force</i>	- -	2008

The Secretary of State and the Treasury, in exercise of the powers vested in them jointly conferred by sections 158(4) and (5), 185 and 186(1) of the Companies Act 1989<sup>(?)</sup>;

The Treasury, in exercise of the powers vested in them by sections 155(4) and (5) and 187(3) of the Companies Act 1989;

And the Treasury, in exercise of the powers conferred on them by section 286 and 428(3) of the Financial Services and Markets Act 2000<sup>(10)</sup>, with the approval of the Secretary of State;

make the following Regulations:

**Citation and commencement**

1. These Regulations may be cited as the Financial Markets and Insolvency Regulations 2008 and shall come into force on [dd mm] 2008.

**Amendment of the Companies Act 1989**

2.—(1) The Companies Act 1989 is amended as follows.

- (2) In paragraph (c) of section 154 (introduction), after “such transactions” insert “or as default fund contribution,”.
- (3) In section 155 (market contracts)—
  - (a) in subsection (2)<sup>(11)</sup>, at the end of paragraph (a) omit “and” and for paragraph (b) substitute—

<sup>(?)</sup> 1989 c.40. The powers originally vested in the Secretary of State under section 155 and 187(3) are now vested in the Treasury and the powers under sections 158(4) and (5), 185 and 186(1) of the Companies Act 1989 are now exercisable by the Secretary of State jointly with the Treasury – see the Transfer of Functions (Financial Services) Order 1992 (S.I. 1992/1315).

<sup>(10)</sup> 2000 c. 8.

<sup>(11)</sup> Section 155(2) and (2A) were substituted for subsection (2) by S.I. 1991/880, regulation 3, subsection s (2)(b) and (3) were amended by S.I. 1998/1748, regulations 3(b) and 4 respectively

“(b) contracts entered into by the exchange, in its capacity as such, with a member of the exchange for the purpose of enabling the rights and liabilities of that member under a transaction to be settled; and

(c) contracts entered into by the exchange with a member of the exchange for the purpose of providing central counterparty clearing services to that member.”;

(b) for subsection (2A)<sup>(12)</sup>, substitute—

“(2A) Where the exchange in question is a recognised overseas investment exchange, this Part does not apply to a contract that falls within paragraph (a) of subsection (2) (unless it also falls within subsection (3)).”;

(c) for subsection (3)<sup>(13)</sup>, substitute—

“(3) In relation to a recognised clearing house this Part applies to—

(a) contracts entered into by the clearing house, in its capacity as such, with a member of the clearing house or with another recognised clearing house for the purpose of enabling the rights and liabilities of that member or other clearing house under a transaction to be settled; and

(b) contracts entered into by the clearing house with a member of the clearing house or another recognised clearing house for the purpose of providing central counterparty clearing services to that member or other clearing house.”; and

(d) after subsection (3) insert—

“(3A) In this section “central counterparty clearing services” means—

(a) the services provided by a recognised investment exchange or a recognised clearing house to the parties to a transaction in connection with contracts between each of the parties and the investment exchange or clearing house (in place of, or as an alternative to, a contract directly between the parties), or

(b) the services provided by one recognised clearing house to another in connection with contracts between them.”.

(4) In subsection (2) of section 158 (modifications of the law of insolvency),

(a) at the end of paragraph (a) omit “and”;

(b) after paragraph (a) insert—

“(aa) proceedings in respect of a recognised clearing house, and”.

(5) In section 159 (proceedings of exchange or clearing house take precedence over insolvency procedures)—

(a) in subsection (1), after “sequestration, or”, insert “in the administration of a company or other body or”;

(b) in subsection (4), after “or bankruptcy”, insert “or in the administration of a company or other body” and after “or sequestration”, insert “or in the administration of a company or other body”; and

(c) in subsection (4A)(b)<sup>(14)</sup>, after “England and Wales,” insert “or in the administration of a company or other body”.

(6) In section 161 (supplementary provisions as to default proceedings)—

(a) in subsection (2), after “liquidator”, insert “, administrator”;

(b) in subsection (4)<sup>(15)</sup>—

(i) after “or paragraph”, insert “40, 41,”; and

(ii) for “including paragraph 43(6) as applied by paragraph 44”, substitute “including those paragraphs as applied by paragraph 44”; and

<sup>(12)</sup> Section 155(2) and (2A) were substituted for subsection (2) by S.I. 1991/880, regulation 3.

<sup>(13)</sup> Section 155(3) was amended by S.I. 1998/1748, regulation 4.

<sup>(14)</sup> Subsection (4A) was inserted by S.I. 1991/880, regulation 4.

<sup>(15)</sup> Subsection (4) was amended by the Enterprise Act 2002, section 248(3), Schedule 17 paragraphs 43, 45.

- (c) in subsection (4) as it has effect, by virtue of section 249(1) of the Enterprise Act 2002, without the amendments made by paragraph 45 of Schedule 17 to that Act, for “10(1)(c), 11(3)” substitute “10, 11”.
- (7) In section 163 (net sum payable on completion of default proceedings)—
- (a) in subsection (2)—
- (i) for “or winding-up order has been made”, substitute “, winding-up or administration order has been made”;
  - (ii) in paragraph (a), for “or winding up”, substitute “, winding up or administration”;
  - (iii) in paragraph (b), after “winding up”, add “or administration”;
  - (iv) after “(within the meaning of section 247 of the Insolvency Act 1986)”, insert “, or enters administration”; and
  - (v) after “the date of the winding-up order” insert “or the date on which the partnership enters administration”.
- (b) in subsection (3)—
- (i) after “sequestration or a winding-up”, insert “or administration”;
  - (ii) in each of paragraphs (a) and (b), for “or winding up”, substitute “, winding up or administration”; and
  - (iii) after “(within the meaning of section 129 of the Insolvency Act 1986)”, insert “or the date on which the body corporate enters administration”;
- (c) after subsection (3)<sup>(16)</sup>, insert—

“(3A) In subsections (2) and (3), a reference to the making of an administration order shall be taken to include a reference to the appointment of an administrator under—

- (a) paragraph 14 of Schedule B1 to the Insolvency Act 1986 (appointment by holder of qualifying floating charge); or
- (b) paragraph 22 of that Schedule (appointment by company or directors).”; and
- (d) in subsection (4), at the end of paragraph (a) omit “or” , at the end of paragraph (b) insert “or”, and, after paragraph (b), insert—

“(c) that an application for an administration order was pending or that any person had given notice of intention to appoint an administrator.”.

(8) In section 164 (disclaimer of property, rescission of contracts, &c)—

- (a) in subsection (1), at the end of paragraph (b) insert “or as default fund contribution”;
- (b) in subsection (3)—
  - (i) after paragraph (b) insert—

“(ba) the provision of default fund contribution to the exchange or clearing house.”;

- (ii) in paragraph (c), after “in relation to a market contract” insert “or as default fund contribution”; and
- (iii) at the end of paragraph (d) insert “or as default fund contribution”;
- (c) in subsection (4)—
  - (i) after “margin in relation to a market contract” insert “or default fund contribution”;
  - (ii) after “the margin” in each of the two places where the expression occurs insert “or default fund contribution”; and
- (d) in subsection (5) at the end insert “or of default fund contribution”.

(9) In section 165 (adjustment of prior transactions)—

- (a) in paragraph (c) of subsection (4), after “clearing house”, insert “in question”; and

<sup>(16)</sup> Schedule B1 to the Insolvency Act 1986 was inserted by s248(2) of the Enterprise Act 2002, Schedule 16.

(b) after subsection (4) insert—

“(5) This section also applies to—

- (a) the provision of default fund contribution to a recognised investment exchange or recognised clearing house,
- (b) any contract effected by a recognised investment exchange or recognised clearing house for the purpose of realising the property provided as default fund contribution, and
- (c) any disposition of property in accordance with the rules of the recognised investment exchange or recognised clearing house as to the application of property provided as default fund contribution.”.

(10) In section 167 (application to determine whether default proceedings to be taken)—

(a) for subsections (1) and (1A) substitute—

“(1) This section applies where a relevant insolvency event has occurred in the case of—

- (a) a member or designated non-member of a recognised investment exchange,
- (b) a member of a recognised clearing house, or
- (c) a recognised clearing house,

The member, designated non-member or clearing house in whose case a relevant insolvency event has occurred is referred to below as “the person in default”.

(1A) For the purposes of this section a “relevant insolvency event” occurs where—

- (a) a bankruptcy order is made,
- (b) an award of sequestration is made;
- (c) an order appointing an interim receiver is made,
- (d) an administration or winding up order is made,
- (e) an administrator is appointed under paragraph 14 of Schedule B1 to the Insolvency Act 1986 (appointment by holder of qualifying floating charge) or under paragraph 22 of that Schedule (appointment by company or directors),
- (f) a resolution for voluntary winding up is passed, or
- (g) an order appointing a provisional liquidator is made.

(1B) Where in relation to a person in default a recognised investment exchange or a recognised clearing house (“the responsible exchange or clearing house”)—

- (a) has power under its default rules to take action in consequence of the relevant insolvency event or the matters giving rise to it, but
- (b) but has not done so,

a relevant office-holder appointed in connection with or in consequence of the relevant insolvency event may apply to the Authority.”;

(b) in subsection (2), for “the exchange or clearing house concerned” substitute “the responsible exchange or clearing house”;

(c) in subsection (3)—

- (i) for “the exchange or clearing house”, in each of the three places where the expression occurs, substitute “the responsible exchange or clearing house”;
- (ii) for “the member or designated non-member in question” substitute “the person in default”; and

(d) in each of subsections (4) and (5), for “the exchange or clearing house” substitute “the responsible exchange or clearing house”.

(11) In section 170 (certain overseas exchanges and clearing houses) for subsection (1) substitute—

“(1) The Secretary of State and the Treasury may by regulations provide that this Part applies in relation to contracts connected with an overseas investment exchange or overseas clearing house which—

- (a) is not a recognised investment exchange or recognised clearing house, but
- (b) is approved by the Treasury in accordance with such requirements as may be so specified,



“(1A) In these Regulations “the Recognition Requirements Regulations” means the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001<sup>(20)</sup>.”

- (3) In regulation 7 (interpretation of Part V), after the definition of “CGO Service member”, insert—  
 ““default fund contribution” has the same meaning as in section 188(3A) of the Act;”.
- (4) In regulation 10 (extent to which charge granted in favour of recognised investment exchange to be treated as market charge)—
- (a) at the end of paragraph (1)(a), insert “or over property provided as a default fund contribution to the exchange”; and
  - (b) in paragraph (1)(b), for the words from “the net sum referred to” to the end, substitute—  
 “any sum due to the exchange from a member of the exchange in respect of unsettled market contracts to which he is a party under the rules referred to in paragraph 12 of the Schedule to the Recognition Requirements Regulations”.
- (5) In regulation 11 (extent to which charge granted in favour of recognised clearing house to be treated as market charge)—
- (a) at the end of paragraph (a), insert “or over property provided as a default fund contribution to the clearing house”; and
  - (b) in paragraph (b), for “the net sum referred to in paragraph 9(2)(a) of Schedule 21 to the Act”, substitute—  
 “any sum due to the clearing house from a member of the clearing house or from another recognised clearing house in respect of unsettled market contracts to which the clearing house is a party under the rules referred to in paragraph 25 of the Schedule to the Recognition Requirements Regulations”.
- (6) In regulation 16 (circumstances in which member or designated non-member dealing as principal to be treated as acting in different capacities)—
- (a) for paragraph (1)(a), substitute—  
 “(a) a market contract, effected as principal by a member or designated non-member of a recognised investment exchange, a member of a recognised clearing house or a recognised clearing house, in relation to which money received by the member or designated non-member is clients’ money for the purposes of rules relating to clients’ money made by the Financial Services Authority, in particular, under section 138 or 139 of the Financial Services and Markets Act 2000;”
  - (b) in paragraph (2) after “recognised clearing house” insert “or a recognised clearing house;” and
  - (c) omit paragraphs (3) and (4).

#### **Amendment of the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001**

4.—(1) The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 are amended as follows.

- (2) In paragraph (1) of regulation 3 (interpretation), after the definition of “the Companies Act”, insert—

““default fund” means the sum of the default fund contributions by the members of a recognised investment exchange to that exchange or by the members of a recognised clearing house to that clearing house or by one recognised clearing house to another to the extent those contributions have not been returned or otherwise applied;

“default fund contribution” has the same meaning as in section 188(3A) of the Companies Act;”.

- (3) In the Schedule—
- (a) in paragraph 12—

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<sup>(20)</sup> S.I. 2001/995.

- (i) after “155(2)(b)”, insert “or (c)”;
  - (ii) in sub-paragraph 2(b) after “different contracts” insert “entered into by the defaulter in one capacity for the purposes of section 187 of the Companies Act”;
  - (iii) after sub-paragraph (2)(b), insert—
    - “(bb) if relevant, for that sum to be aggregated with, or set off against, any sum owed by or to the investment exchange by or to AP under an indemnity given or reimbursement or similar obligation in respect of a margin set off agreement in which the defaulter chose to participate so as to produce a net sum.”;
    - (iv) for sub-paragraph (2)(c), substitute—
- “(c) for the net sum referred to in paragraph (b) or, if relevant, the net sum referred to in paragraph (bb)—
- (i) if payable by the defaulter to the exchange, to be set off against—
    - (aa) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);
    - (bb) to the extent (if any) that any sum remains after set off under paragraph (aa), any default fund contribution provided by the defaulter remaining after any application of such contribution;
    - (cc) to the extent (if any) that any sum remains after set off under paragraph (bb), such other funds, including the default fund, or resources as the exchange may apply under its default rules;
  - (ii) if payable by the exchange to the defaulter, to be aggregated with—
    - (aa) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);
    - (bb) any default fund contribution provided by the defaulter remaining after any application of such contribution;”;
    - (v) after sub-paragraph (2), insert—

“(2A) In sub-paragraph (2), “margin set off agreement” means an agreement between the exchange and AP permitting any eligible position to which the Participant Member is party with the exchange and any eligible position to which the Participant Member is party with AP to be taken into account in calculating a net sum owed by or to the Participant Member to either the exchange or AP and/or margin to be provided to, either or both, the exchange and AP.

(2B) In sub-paragraph (2)—

“AP” means a person other than the exchange of whom a Participant Member is a member;

“eligible position” means any position which may be included in the set off calculation;

“Participant Member” means a person who—

- (a) is a member of the exchange;
- (b) is a member or participant of AP; and
- (c) chooses to participate, in accordance with the rules of the exchange, in such agreement.

(2C) The property, contribution, funds or resources referred to in paragraph (2)(c), against which the net sum is to be set off (or with which it is to be aggregated) are subject to any unsatisfied claims arising out of the default of a defaulter before the default in relation to which the calculation is being made.”;

(b) after paragraph 12, insert—

“12A. The rules of the exchange must provide that, in the event of a default, any default fund contribution provided by the defaulter shall only be used in accordance with paragraph 12(2)(c)(i) or (ii).”;

(c) in paragraph 15(1), at the end insert, “other than a client account of the defaulter.”;

(d) after paragraph 15(2), insert—

“(3) For the purposes of this paragraph, “client account” means an account held by the exchange in the name of the defaulter in which relevant transactions effected by the defaulter have been recorded.

(4) In sub-paragraph (3) “relevant transaction” has the same meaning as in regulation 16(1) of the Financial Markets and Insolvency Regulations 1991.”;

(e) in paragraph 25—

(i) in sub-paragraph (1)(b), after “different contracts” insert “entered into by the defaulter in one capacity for the purposes of section 187 of the Companies Act”;

(ii) after sub-paragraph (1)(b), insert—

“(bb) if relevant, for that sum to be aggregated with, or set off against, any sum owed by or to the clearing house by or to AP under an indemnity given or reimbursement or similar obligation in respect of a margin set off agreement in which the defaulter chose to participate so as to produce a net sum.”;

(iii) for sub-paragraph (1)(c), substitute—

“(c) for the net sum referred to in paragraph (b) or, if relevant, the net sum referred to in paragraph (bb)—

(i) if payable by the defaulter to the clearing house, to be set off against—

(aa) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);

(bb) to the extent (if any) that any sum remains after set off under paragraph (aa), any default fund contribution provided by the defaulter remaining after any application of such contribution;

(cc) to the extent (if any) that any sum remains after set off under paragraph (bb), any such funds, including the default fund, or resources as the clearing house may apply under its default rules;

(ii) if payable by the clearing house to the defaulter, to be aggregated with—

(aa) any property provided by or on behalf of the defaulter as cover for margin (or the proceeds of realisation of such property);

(bb) any default fund contribution provided by the defaulter remaining after any application of such contribution; and”;

(iv) after sub-paragraph (1), insert—

“(1A) In sub-paragraph (1), “margin set off agreement” means an agreement between the clearing house and AP permitting any eligible position to which the Participant Member is party with the clearing house and any eligible position to which the Participant Member is party with AP to be taken into account in calculating a net sum owed by or to the Participant Member to either the clearing house or AP and/or margin to be provided to, either or both, the clearing house and AP.

(1B) In sub-paragraph (1A)—

“AP” means a person other than the clearing house of whom a participant member is a member;

“eligible position” means any position which may be included in the set off calculation;

“Participant Member” means a person who—

(a) is a member of the clearing house;

(b) is a member or participant of AP; and

(c) chooses to participate, in accordance with the rules of the clearing house, in such agreement.

(1C) The property, contribution, funds or resources referred to in paragraph (1)(c), against which the net sum is to be set off (or with which it is to be aggregated) are subject to any unsatisfied claims arising out of the default of a defaulter before the default in relation to which the calculation is being made.”;

(f) after paragraph 25, insert—

“25A. The rules of the clearing house must provide that in the event of a default, any default fund contribution provided by the defaulter shall only be used in accordance with paragraph 25(1)(c)(i) or (ii).”;

(g) in paragraph 28(1), at the end insert, “other than a client account of the defaulter.”;

(h) after paragraph 28(2), insert—

“(3) For the purposes of this paragraph, “client account” means an account held by the clearing house in the name of the defaulter in which relevant transactions effected by the defaulter have been recorded.

(4) In sub-paragraph (3) “relevant transaction” has the same meaning as in regulation 16(1) of the Financial Markets and Insolvency Regulations 1991.”

[ ] 2008 Two of the Lords Commissioners of Her Majesty’s Treasury

[ ] 2008 Parliamentary Under Secretary of State  
Department for Business Enterprise and Regulatory Reform

### EXPLANATORY NOTE

*(This note is not part of the Regulations)*

These Regulations change the insolvency regime that applies to any exchange that runs in-house clearing arrangements which is a “recognised investment exchange” (“RIE”) and any central counterparty clearing house which is a “recognised clearing house” (“RCH”) within the meaning of the Financial Services and Markets Act 2000 (c. 8). They do so by amending Part 7 of the Companies Act 1989 (c. 40) (“Part 7”); the Financial Markets and Insolvency Regulations 1991 (S.I. 1991/880) (the “1991 Regulations”) and the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (S.I. 2001/995) (the “2001 Regulations”).

These Regulations amend Part 7, the 1991 Regulations and the 2001 Regulations so that they provide further protection for the actions of RIEs and RCHs in the event of default by any of their members on the obligations they have entered into in the course of buying or selling financial instruments. The amendments comprise

- a broadening of the definition of “market contracts” to which Part 7 applies;
- inclusion of default fund contributions within the protections of Part 7;
- provisions amending Part 7 so that it takes account of administration on a basis equivalent to bankruptcy and winding up;
- provision to ensure default rules refer to and take into account cross margining agreements; and
- provisions enabling the extension of the default rules of RIEs and RCHs so that a surplus held on a house account of a member may be used to make up a deficit on the client account of the same members.

Regulation 2 amends Part 7 as follows.

Paragraph (2) makes a consequential amendment to section 154. Paragraph (3) amends section 155 (market contracts). The effect of these amendments is that market contracts no longer have to relate to transactions in investments only and include contracts with members for the purposes of providing central counterparty clearing services to them. Paragraphs (4) to (7), (10) and (12) amend various sections of Part 7 so that they take account of administration on an equivalent basis to bankruptcy and winding up. Paragraphs (8) and (9), (11), (13) and (14) amend various sections of Part 7 so that where certain provisions of the Insolvency Act 1986 are disapplied in relation to margin, they are also disapplied in relation to default fund contribution (as defined by the amendment in paragraph (15)). This provides for equivalent protection in the application by a RIE or RCH of property held as default fund contribution as for property held as margin.

Regulation 3 amends the 1991 Regulations as follows.

Paragraph (4) amends paragraph (1) of regulation 10 (extent to which charge granted in favour of recognised investment exchange to be treated as market charge) so that it also applies to a charge granted over property provided as default fund contribution to a RIE and, in the case of a recognised UK investment exchange, it secures the obligation to pay to the exchange any sum due to it from a member in respect of unsettled market contracts.

Paragraph (5) amends paragraph (1) of regulation 11 (extent to which charge granted in favour of recognised clearing house to be treated as market charge) in the same ways in relation to RCHs. Paragraph (6) amends regulation 16 (circumstances in which member or designated non-member dealing as principal to be treated as acting in different capacities) omitting paragraphs (3) and (4) to remove the definition of relevant investment to which the reference in sub-paragraph (a) is also removed to broaden the scope of contracts falling within the regulation. The reference to client rules is updated.

Regulation 4 amends the 2001 Regulations as follows.

Paragraph (3) amends the Schedule to the 2001 Regulations. Sub-paragraphs (a) to (d) amend the requirements relating to default rules in respect of market contracts with RIEs in Part 2 (recognition requirements for investment exchanges: default rules in respect of market contracts) of the Schedule. These amendments change the requirements for the default rules relating to set off and aggregation so that, where applicable and in the prescribed order, they must also take account of a defaulter's house account surpluses, margin set off agreements, default fund contribution and the default fund more generally. Sub-paragraphs (e) to (h) make equivalent amendments to the requirements relating to default rules in respect of market contracts with RCHs in Part 4 (recognition requirements applying to clearing houses: default rules in respect of market contracts) of the Schedule.

# B

## INITIAL IMPACT ASSESSMENT - FINANCIAL MARKETS AND INSOLVENCY REGULATIONS 2008

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See overleaf.

## Summary: Intervention & Options

<b>Department /Agency:</b> <b>HM Treasury</b>	<b>Title:</b> <b>Impact Assessment of the proposal to reform Part 7 of the 1989 Companies Act</b>	
<b>Stage: Consultation</b>	<b>Version: 1</b>	<b>Date: 16/07/08</b>
<b>Related Publications:</b>		

Available to view or download at:

<http://www.>

Contact for enquiries: Henry Rigg

Telephone: 020 7270 4704

**What is the problem under consideration? Why is government intervention necessary?**

Since 1989 there have been significant developments in the scale, nature and organisation of clearing houses and investment exchanges activities. Part 7 of the Companies Act 1989 has never been comprehensively overhauled and not kept pace with these changes. Without government intervention, legal uncertainty may remain in relation to; default fund arrangements; cross-margining agreements between clearing houses; and the definition of a "market contract. Such uncertainty increases the systemic risk. Furthermore, the current prohibition on the use of house account surpluses to meet deficits on client accounts adds to the systemic risks in wholesale markets.

**What are the policy objectives and the intended effects?** To update legislation that safeguards financial markets in relation to central counterparty clearing houses and investment exchanges, enhancing the ability of clearing houses and investment exchanges to ensure that in the event of a market participants default, markets will continue to operate with integrity and confidence. The Government intends to achieve this through a set of changes to Part 7 of the Companies Act relating to: default fund arrangements; the use of house account surpluses to meet deficits on client accounts; cross-margining agreements between clearing houses; the definition of a "market contract"; and certain amendments to the law of administration.

**What policy options have been considered? Please justify any preferred option.**

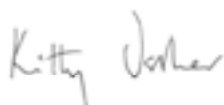
1. Do nothing
2. Minor legislative amendments to the insolvency regime for central counterparty clearing houses and investment exchanges. The legislative option is preferable as it would reduce the systemic risk, support industry developments in operations, risk management and governance and promote the government's objective to provide the conditions for efficient, stable and fair financial markets.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Within three years after implementation.**

**Ministerial Sign-off** For consultation stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:



.....Date: 18 July 2008

## Summary: Analysis & Evidence

**Policy Option: 2.**

**Description: A package of minor changes to amend the insolvency regime for central counterparty clearing houses & investment exchanges.**

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' The costs are likely to be restricted to those associated with clearing houses promulgating changes to the fine print of their terms of business, and the costs of their members in assimilating those changes.
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	<b>£ 1.9m</b>		
	<b>Average Annual Cost</b> (excluding one-off)		
	<b>£ Nil</b>		<b>Total Cost (PV)</b> <b>£ 1.9</b>
Other <b>key non-monetised costs</b> by 'main affected groups'			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' Given the intangible value of increasing confidence in the robust operation of the market and difficulties in estimating the probability of any systemic event, it is not feasible to estimate a figure.
	<b>One-off</b>	<b>Yrs</b>	
	<b>£ N.A.</b>		
	<b>Average Annual Benefit</b> (excluding one-off)		
	<b>£ N.A.</b>		<b>Total Benefit (PV)</b> <b>£ N.A.</b>
Other <b>key non-monetised benefits</b> by 'main affected groups' The legislative option would reduce the systemic risk, support industry developments in operations, risk management and governance and promote the government's objective to provide the conditions for efficient, stable and fair financial markets.			

### Key Assumptions/Sensitivities/Risks

Costs based on 100 hours of senior legal and management work and 100 hours of general management effort.

Price Base Year 2008	Time Period Years 0	<b>Net Benefit Range (NPV)</b> <b>£ N.A.</b>	<b>NET BENEFIT (NPV Best estimate)</b> <b>£ N.A.</b>
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What is the geographic coverage of the policy/option?		UK	
On what date will the policy be implemented?		2008	
Which organisation(s) will enforce the policy?		FSA	
What is the total annual cost of enforcement for these organisations?		£ 0	
Does enforcement comply with Hampton principles?		yes	
Will implementation go beyond minimum EU requirements?		N/A	
What is the value of the proposed offsetting measure per year?		£ N.A.	
What is the value of changes in greenhouse gas emissions?		£ N.A.	
Will the proposal have a significant impact on competition?		No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium      Large
Are any of these organisations exempt?	No	No	N/A      N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			(Increase - Decrease)
Increase of	£ N.A.	Decrease of	£ N.A.
<b>Net Impact</b>			<b>£ N.A.</b>

Key: Annual costs and benefits: Constant Prices (Net) Present Value

# Evidence Base (for summary sheets)

## 1. PROPOSAL OBJECTIVES

To update legislation that safeguards financial markets, so that in the event of a market participant's default, market integrity continues to be guaranteed.

The rapid evolution of financial markets and their arrangements for addressing risk, including default, means that there is a requirement to update these provisions. The ongoing need for updates was anticipated by the inclusion of significant powers to revise the legislation by statutory instruments.

Existing legislation and regulation no longer adequately reflects the range of contracts cleared by central counterparties and their role in those contracts. It does not explicitly acknowledge the utilisation of default funds, which have become an important part of the risk armoury of central counterparties and merit equivalent protection to that provided for 'margin'. Where investment firms maintain separate 'house' accounts and 'client' accounts with the central counterparty, the legislation protects house account resources from calls to offset losses on client accounts. Lastly, the existing regime needs adjusting to address the situation where investors participate in more than one exchange, and those exchanges have mutual clearing arrangements to ensure that the client's margin requirement takes account of the aggregate position across the exchanges.

The proposals are in keeping with the 2004 joint recommendations of the Bank for International Settlements (BIS) and the International Organisation of Securities Commissions (IOSCO). Recommendation 1 of that report, covering 'legal risk' includes the following explanation at paragraph 4.1.3 -

"The legal framework should support the essential steps that a CCP takes to handle a defaulting or insolvent participant, including any transfers and closing-out of a direct or indirect participant's positions. A CCP must act quickly in the event of a participant's default, and ambiguity over the enforceability of these procedures could delay, and possibly prevent altogether, a CCP from taking actions that fulfil its obligations to non-defaulting participants or minimise its potential losses. Insolvency law should support isolating risk and retaining and applying collateral (including margin) and cash payments previously paid into a CCP, notwithstanding a default or the commencement of an administration or bankruptcy proceeding by or against a participant."

## 2. BACKGROUND

The proposals relate to the regime in Part 7 of the Companies Act 1989. This regime modifies normal insolvency procedures to protect the actions of recognised clearing houses and recognised investment exchanges in their role as central counterparties to market contracts.

The concept of a central counterparty arose in part to address the risk that any market contract is vulnerable to default by either the buyer or the seller. The risk is more pronounced in the case of contracts with an extended life, such as derivatives. The rules of the exchange and/or the clearing house secure that, by novation, the central counterparty becomes contractual intermediary – buying from the seller and selling to the buyer, so that performance of the contract is guaranteed, subject of course to the viability of the central counterparty itself.

Under the Financial Services and Markets Act 2000, a recognised investment exchange must either provide satisfactory arrangements for its own central counterparty services, or make arrangements for performance to be ensured by another party. The rules of the exchange and/or central counterparty require clearing members to provide the central counterparty with collateral based on volumes and levels of risk of the business they clear.

In the event that a buyer or seller does default, the Part 7 regime enables the central counterparty to take action to close out the defaulter's unsettled market contracts for securities in accordance with its default rules. This may include offsetting profits and losses on different contracts and utilising resources provided as collateral. The liquidator for the defaulter is prevented from unpicking these transactions.

Clearing houses, in keeping with standard industry practice, adopt a number of approaches to mitigating risks, including vetting and monitoring the viability of clearing members, assessing risk exposure and the collateral required as margin to cover that risk from individual members on an intra-day basis, requiring those members also to contribute to a default fund against the eventuality that individual margin provision is insufficient to offset default liabilities, and maintaining additional default insurance cover available before any recourse to own capital.

### 3. KEY ASSUMPTION AND OPTIONS SUMMARY

#### KEY ASSUMPTION

- Hourly rates are based on average charge out rates of £402 for legal partners and £170 for legal assistants.
- The cost of assimilation by members is estimated at up to ten hours of work per member, mainly by compliance staff, for 120 members.
- FSA costs based on 30 hours of associate time at a cost of £150 per person hour.

#### OPTIONS SUMMARY

OPTION	COSTS	BENEFITS
<b>1. DO NOTHING</b>	The 'do nothing' option would conserve the status quo at nil cost.	The 'do nothing' option would conserve the status quo.
<b>2. A PACKAGE OF MINOR LEGISLATIVE CHANGES</b>	<b>£ 1.9 M</b> The costs of the legislative option are largely restricted to the costs of clearing houses promulgating changes to the fine print of their terms of business, and the costs of their members in assimilating those changes	Would increase protection against the structural risk of a systemic collapse, support industry developments in operations, risk management and governance and promote the government's objective to provide the conditions for efficient, stable and fair financial markets. Further, this option reduces any risk that the present operation of the default rules could be successfully legally challenged.

#### 4. OPTION 1 – DO NOTHING

The existing provisions have not been tested recently. Defaults are infrequent and the circumstances that would cause existing safeguards to unravel would be more unusual still. Even if circumstances did conspire towards the worst, the various stakeholders would have a very strong interest in heading off market collapse. However, the existing provisions do not reflect the current products cleared, are out of date in some cases, and in the case of the amendments required to take account of the changes to administration brought about by the Enterprise Act, are vital to protect the robustness of the default rules.

Confidence is the oxygen of financial markets. UK markets enjoy enviable pre-eminence on the global stage and play a key part in the economic life of the UK. The government is committed to providing appropriate underpinning for efficient, stable and fair financial markets, against a background of lively international competition.

##### Benefits

The 'do nothing' option would conserve the status quo at nil cost.

##### Costs

The 'do nothing' option would conserve the status quo at no direct cost. The potential economic impact from systemic collapse is of course enormous, although the likelihood is remote: the City contributes some 3% of UK GDP and securities trading accounts for some 35% of this. The potential cost from loss of confidence and reputation is also sizeable, because erosion of status in the global market place would tend to be self-perpetuating.

## 5. OPTION 2 – A PACKAGE OF MINOR LEGISLATIVE CHANGES

### Benefits

The package of minor legislative changes would reduce the systemic risk, support industry developments in operations, risk management and governance and promote the government's objective to provide the conditions for efficient, stable and fair financial markets. Further, this option reduces any risk that the present operation of the default rules could be successfully legally challenged.

The proposed amendments to Part 7 of the 1989 Companies Act explicitly provide for -

- the operation of a default fund to address the situation where a defaulter's net position exceeds the amount of collateral calculated for margin. Certainty of access to such funds is essential if clearing houses are successfully to contain systemic risk in the case of member failure in volatile market conditions;
- the use of surpluses from a clearing members trading on his own account to meet deficits on client accounts. This will ensure that client segregation protects the client not the clearing member as intended by the 1989 regime;
- cross-margining agreements between central counterparty clearing houses, which allow them to pool risk in respect of members they have in common. Such agreements can bring significant benefits for the members of central counterparty clearing organisations by providing savings on capital to be posted as margin;
- a wider definition of "market contracts" to reflect the evolution of traded instruments, congruent with other legislation;
- the need to reflect certain amendments to the law of administration.

These changes are necessary to support best practice in UK financial markets, are in keeping with European and international recommendations and standards and, in the case of the amendments required to take account of the changes to administration brought about by the Enterprise Act, are vital to protect the robustness of the default rules.

### Costs

The costs of the legislative option are largely restricted to the costs of clearing houses promulgating changes to the fine print of their terms of business, and the costs of their members in assimilating those changes. The legislative changes are broadly aimed at reinforcing existing protections, with no price implications. We have assessed the likely costs based on 100 hours of senior legal and management work and 100 hours of general management effort. But their costs have largely already been expended. The cost of assimilation by members is estimated at up to ten hours of work per member, mainly by compliance staff, for 120 members. Hourly rates are based on average charge out rates of £402 for legal partners and £170 for legal assistants. The total projected, maximum implementation costs from these estimates are some **£1.9m**

In addition, the FSA is likely to incur some relatively small one-off cost as a result of the proposed legislation being implemented. These are estimated by the FSA to be in the region of £ 4,500, based on 30 hours of associate time at a cost of £150 per person hour.

It is not anticipated that the FSA, clearing houses or market participants will face any material costs on an on-going basis.

## 6. RISK, UNCERTAINTY AND UNINTENDED CONSEQUENCES

It needs to be emphasised that defaults under the provisions currently in place have been few and far between – only four cases since the 1990s. The ready settlement of those cases within the default rules is a testament to the robustness of those arrangements and supporting governance. Regulatory requirements relevant to central counterparties reinforce the necessity of those default rules continuing to have a sound legislative and regulatory underpinning.

The main risk is that, without adequate legislative support, the default rules themselves could be contested, bringing instability to the market. The secondary risk is that UK markets simply lose confidence and competitive advantage.

The risk of implementing changes is that as this is a technical and rapidly evolving area of practice:

- the measures could prove to be ill-founded;
- sound, successfully implemented measures might still be prey to further developments in the market place.

We cannot entirely rule out the risk of further developments in the market place. Due to the nature of such operations, it is entirely possible that further changes will present themselves before very long. (It may be that the gradual completion of EU legislation covering financial services and company law may provide a new basis for national legislation.) What we have done, as far as possible, is to draft in terms of principle, rather than current practice - which may not remain current for very long.

## **7. COMPETITION ASSESSMENT**

Neither proposal has significant implications for competition. The proposals are to do with market infrastructure and have no impact on entry to those markets or on conduct of business. Arguably, by strengthening assurance against default, the legislative option bolsters confidence for all and allows firms with lower capitalisation to participate on the most equal footing.

## **8. IMPACT ON SMALL FIRMS**

The proposals do nothing to affect current market structures, whereby participating small firms would continue to have their trades cleared through the much smaller number of central counterparty clearing members – typically banks and other major market makers.

## **9. EQUALITY ASSESSMENTS**

The Legislation should have no impact on race, disability or gender equality.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	Yes	No
Health Impact Assessment	No	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	No	No

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