

INDIRECT CLEARING

Part VII amended just in time for 3 January indirect clearing changes

Amidst the mass of legislation before Parliament at the end of 2017 and a pre-MiFID 2 rush, one technical legislative amendment was passed with particular relevance to the legal certainty of the financial market clearing infrastructure in the UK. Part VII of the Companies Act 1989 operates so as to protect certain arrangements from insolvency challenge under English law.

On 3 January 2018 the provisions on indirect clearing arrangements under Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories ("**EMIR**") and Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments ("**MiFIR**") came into force. Just before Christmas, the UK government introduced the Companies Act 1989 (Financial Markets and Insolvency) (Amendment) Regulations 2017 (SI 2017 No. 1247) (the "**IC Part VII Regulations**"), bringing within the scope of Part VII of the Companies Act 1989 ("**Part VII**") some of the indirect clearing arrangements discussed below.

The requirements under the RTS

An indirect clearing arrangement is a set of contractual relationships between a central counterparty ("**CCP**"), a clearing member ("**CM**"), the direct client of a CM ("**direct client**") and the client of the direct client ("**indirect client**") that allows the direct client of a CM to provide clearing services to an indirect client. Requirements with regard to indirect clearing arrangements were first introduced in article 4(3) of EMIR for OTC derivatives subject to the clearing obligation, and the concept was later included at article 30 of MiFIR in respect of exchange-traded derivatives. On 3 January 2018, the relevant Regulatory Technical Standards under MiFIR and EMIR ("**RTS**") came into effect, specifying various requirements for indirect clearing arrangements, depending on the account type used (at the CCP and CM level).

Specifically, the RTS contain provisions relating to the segregation of assets (margin) and positions (transactions) of indirect clients, as well as the default management processes of the CM in the event of a direct client's default. Prompt liquidation of the assets and positions relating to the relevant account

Key issues

- IC Part VII Regulations entered into force on 3 January and brought within the scope of Part VII certain indirect clearing arrangements
- The segregation of assets and positions of indirect clients pursuant to the RTS is preserved as statutory insolvency set-off is disappplied
- Default management actions under the RTS, such as porting, leapfrog, the prompt liquidation of assets and positions relating to an account and the return of the liquidation balance to the direct client for the account of the indirect clients, are protected from insolvency challenge

must be possible, and the CM must be able to readily return any balance from the liquidation to the direct client for the account of the indirect clients. In addition, in the case of a gross omnibus indirect account, the CM must contractually commit itself to trigger the procedures for the transfer of the positions and assets of the direct client to another (back-up) direct client or CM ("**porting**"), or to make a direct payment to the indirect clients ("**leapfrog**").

The Issue

From an English insolvency law perspective, in the event of an English direct client insolvency, the segregation requirements stipulated in the RTS, and the ability of the CM to port, make a leapfrog payment and/or liquidate the assets and positions relating to the account and return the balance to the direct client for the account of the indirect clients, would (in the absence of any overriding insolvency law protection) have either been curtailed by operation of law (by virtue of mandatory set-off) or open to challenge by the appointed insolvency practitioner dealing with the direct client's estate.

The Solution

To the relief of the industry, the government enacted the IC Part VII Regulations, extending the insolvency protections of Part VII to the indirect clearing arrangements described above.

The IC Part VII Regulations:

- amend section 182A of Part VII so that the segregation of the assets and positions of indirect clients pursuant to article 3(1) of the RTS (at the CCP level) and article 4(2) of the RTS (at the CM level) is preserved by virtue of the disapplication of any potential statutory insolvency set-off override;
- amend section 155A of Part VII so that all default management actions carried out pursuant to articles 4(6) and 4(7) of the RTS (namely, actions to achieve porting, leapfrog and the prompt liquidation of the assets and positions relating to the relevant account, as well as the return of the liquidation balance to the direct client for the account of the indirect clients) are protected from insolvency challenge;
- go beyond the previous amendments to section 155A(4)(aa) of Part VII, which, in the context of the Commission Delegated Regulation (EU) No 149/2013 supplementing EMIR of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements ("**EMIR Level 2 Regulation**"), was confined to "payments of money by a clearing member to indirect clients in accordance with article 4(5) of the EMIR Level 2 Regulation". This meant that porting was protected by virtue of section 155A(4)(c) of Part VII, and therefore at the CCP-CM level (and not at the direct client-CM level) and only (i) as determined in accordance with the default rules of a CCP and (ii) not including excess margin.

The IC Part VII Regulations have been welcomed as a helpful measure by the government amongst the plethora of legislative changes that came into effect in January.

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