EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (OVER THE COUNTER DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES) (No. 2) REGULATIONS 2013

2013 No. 1908

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations relate to the clearing of financial transactions through recognised clearing houses. They amend insolvency law to facilitate the segregation and transfer of indirect clients' assets and positions, and make minor amendments to the supervisory, investigatory and enforcement powers on Bank of England and the Financial Conduct Authority. They require recognised clearing houses to maintain recovery plans specifying the steps they will take if the continuity of their services is disrupted, and require recognised central counterparties to have rules to allocate losses if their solvency is threatened.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

Provisions amending insolvency law and amending the powers conferred on the Bank of England and the Financial Conduct Authority

4.1 These provisions implement in part:

- Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on over the counter derivatives, central counterparties and trade repositories (OJ no L 201, 27.7.2012, p1), (more commonly known as the European Markets Infrastructure Regulation or "EMIR");

- Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012
supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP (OJ no L 52, 23.2.2013, p11) ("the Regulatory Technical Standard").

4.2 In relation to EMIR, Explanatory Memorandum 13917/10 was sent to both scrutiny committees on 22 September 2010. It was cleared by the House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee on 3 May 2011. The House of Commons EU Economic and Financial Affairs and International Trade Sub-Committee held the document under scrutiny whilst negotiations progressed. The Government was able to secure an outcome that broadly met its objectives and the Committee's concerns at an Economic and Financial Affairs Council meeting on 4 October 2011, and therefore decided to override scrutiny. The Government wrote to the Commons Sub-Committee informing them of this and the reason for the override. The Sub-Committee accepted the Government's explanation and cleared the documents on 12 October 2011.

4.3 The Regulatory Technical Standard was made by the European Commission under powers conferred on it by EMIR. The provisions on indirect clearing arrangements are relevant to this Statutory Instrument.

4.4 Both EMIR and the Regulatory Technical Standard are directly applicable and many aspects do not require transposition into UK law. The Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013 (S.I. 2013/504) made a number of amendments to UK law to implement provisions of EMIR, to confer supervisory and enforcement powers on the Bank of England and the Financial Conduct Authority, and facilitate the segregation and porting of clients' and indirect clients' assets and positions on the failure of a clearing member of a recognised central counterparty. These Regulations further implement EMIR and the Regulatory Technical Standard by making minor technical changes to the supervisory and enforcement powers conferred on the authorities. They also amend insolvency law to facilitate the segregation and porting of indirect clients' assets and positions on the failure of a client providing indirect clearing services – see paragraph 7.13 of the Explanatory Memorandum to the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013. An indirect client is a client of a client of a clearing member.

Provisions on recovery plans and loss allocation

4.5 These provisions amend the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001(S.I. 2001/995)("the Recognition Requirements Regulations"). They impose new requirements on recognised central counterparties and recognised clearing houses which are not central counterparties. Recognised central counterparties will be required to maintain effective arrangements for the allocation of losses that threaten their solvency. Both categories of clearing house will be required to maintain plans specifying the steps they will take to maintain the continuity of services if that continuity is threatened. Transitory provision is also made applying the requirements for recovery plans and loss allocation to recognised clearing houses which apply

for authorisation under EMIR in instances where their applications have not been determined by certain specified dates.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Financial Secretary to the Treasury, Greg Clark MP, has made the following statement regarding Human Rights:

> *In my view the provisions of the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) (No. 2) Regulations 2013 are compatible with the Convention rights.*

7. Policy background

What is being done and why

7.1 The financial crisis of 2008 revealed problems within the over-the-counter ("OTC") derivatives markets; most notably deficiencies in management of counterparty credit risk, raising systemic risk concerns, and a lack of transparency regarding risk concentrations. At the G20 meeting in Pittsburgh in September 2009, leaders agreed that "...all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements." Following the G20 commitment, the European Union sought to address these problems through EMIR. EMIR sets out regulatory and prudential requirements and an authorisation and supervision regime for central counterparties ("CCPs") in the EU. EMIR also mandates the central clearing of certain standardised OTC derivatives.

7.2 EMIR officially entered into force on 16 August 2012. However many of its substantive provisions did not take effect until the regulatory technical standards relating to them (and developed by the European Securities and Markets Authority and European Banking Authority and adopted by the Commission). The Commission published the regulatory technical standards in the Official Journal of the EU on 23 February 2013, and they entered into force on 15 March 2013.

7.3 EU Regulations take automatic effect in UK law without transposition, and so to a very large extent do not need any domestic implementation. However, Member States are obliged to ensure that domestic law is compatible with EU Regulations (so any inconsistencies need to be removed) and may need to

facilitate certain provisions with supplementary domestic legislation. To that end HM Treasury and the Department for Business, Innovation and Skills made the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013.

7.4 This statutory instrument made various technical amendments to the UK's domestic legislation to facilitate and implement certain requirements of EMIR. However, the Treasury considered that additional engagement with industry was essential in order to assess whether further legislative changes were required with regard to indirect clearing and, if so, how they could accurately reflect best market practice. "Indirect clearing" describes arrangements involving a CCP, a clearing member of the CCP, a client of the clearing member, and a client of that client (an "indirect client"). After the first statutory instrument came into force the Treasury conducted a series of informal consultations on indirect clearing, responses to which have been taken into account in these current Regulations. Accordingly, these Regulations amend insolvency law to facilitate the segregation of indirect clients' assets and positions at clearing member level. They also amend insolvency law to facilitate the transfer of indirect clients' assets and positions if the client providing the indirect clearing services defaults. This transfer could be to another client, the defaulting client's clearing member or another clearing member. These amendments will, in particular, offer market participants additional certainty that porting can be achieved without the risk of challenge under UK insolvency law.

7.5 EMIR requires competent authorities to have all the supervisory, investigatory and enforcement powers necessary for the exercise of their functions. These Regulations also contain further provision for the supervision of market participants as well as for the enforcement of EMIR and sanctions for breaches of EMIR. These changes will include:

- Providing the FCA with powers to obtain information from third country entities, who are already required to provide such information to a competent authority under EMIR;
- Providing the FCA with the power to specify the form and content of information provided by regulated market participants, who are already required to provide such information to a competent authority under the Regulatory Technical Standard;
- Providing the FCA the power to issue a statement of censure as an alternative to a penalty for breaches of EMIR and its implementing legislation; and
- Establishing a procedural framework for the exercise of the powers of the Bank of England to remove a member of the board of directors of a recognised central counterparty, covering notification, the right to make representations and appeal.

7.6 HM Treasury have also identified that a change should be made to the UK legislation transposing Article 38(3) of Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments. The change will ensure the requirements under Chapter 1A of

Part 18 of FSMA 2000 (requirements to give notice of changes in control over a recognised investment exchange) do not apply to overseas investment exchanges. This will reduce potential burden on overseas firms caused by a discrepancy with the FCA rule book. It also restores the position to that which obtained when Directive 2004/39/EC was originally transposed.

7.7 Given the systemic significance of clearing houses, it is essential that arrangements are in place to guard against more extreme shocks. Clearing houses have, in most cases, begun the process of putting loss allocation rules in place to allow for circumstances where losses exceed existing resources. Making loss allocation rules mandatory for all recognised central counterparties and across all clearing house products, as this instrument does, will significantly reduce the likelihood of a clearing house failing in a way that would constitute a threat to wider financial stability or potentially put public finances at risk through a resolution.

7.8 This is consistent with the international Principles for Financial Market Infrastructures developed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO). The Bank of England's Financial Policy Committee has also encouraged the development of loss allocation rules. These rules would be expected to reinforce existing arrangements (posting of initial margin and other collateral, default fund contributions, capital) for managing financial shocks to the CCPs, and, therefore, prevent failure and to be able to ensure service continuity.

7.9 Complementing this change, and to aid recovery and resolution planning, this instrument makes a change to the recognition requirements so as to stipulate that a UK recognised clearing house must have a recovery plan in place. This is analogous to the requirement under Financial Services Act 2012 for banks to maintain recovery and resolution plans. This is also consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures, which state that an FMI should prepare appropriate plans for its recovery or orderly wind-down (Principle 3 Key Consideration 4). It is also consistent with the objectives of the EMIR draft technical standards submitted by the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA). Robust recovery plans enhance a company's resilience to a shock by improving its ability to deal with an adverse set of consequences if it arises.

Consolidation

7.10 These Regulations make minor amendments to domestic legislation. .Since the amendments are limited in scope, consolidation is not merited.

8. Consultation outcome

8.1 The Treasury did not consult on all aspects of the implementation of EMIR. The enforcement powers of the competent authorities are largely similar to the

powers in relation to the existing regime, which are familiar to market participants. As there was therefore a very limited way in which a consultation could affect the draft legislation, it was decided that no consultation was necessary on this issue.

8.2 In relation to indirect clearing, the Treasury conducted two targeted informal consultations. On 28 March 2013, the Treasury launched its first informal consultation with key stakeholders who had been involved in the negotiation and earlier implementation of EMIR to assess the changes covering indirect clearing and the proposed amendments to Part 7 of the Companies Act 1989. The Treasury held a meeting with consultees and received several detailed responses by the close of the consultation on 15 April 2013, which were taken into account when drafting these regulations. This was followed with a further round of informal consultation on 2 May 2013 on Part 7 of the Companies Act 1989. The Treasury held a further stakeholder meeting and received responses to the second round of consultation by 17 May 2013. These were taken into account when drafting the regulations.

8.3 The Treasury informally consulted the industry and its representatives on the proposal to change the recognition requirements for CCPs to make loss allocation arrangements and recovery plans mandatory. The consultation ran for four weeks from 23 January 2013 to 20th February 2013. Respondents broadly supported the Government's approach. However, there were a number of concerns expressed around timing, specifically whether the UK was pre-judging international work in this area. The Government is working closely with international colleagues to ensure that its views, and those of the industry, are represented at an international level. However, the timetable for the international work is uncertain. Once it has concluded, it will take a number of years to implement through legislation and become effective in the UK. Therefore, the Government has decided to proceed with interim measures. The measures the Government has proposed are consistent with emerging international views.

8.4 Respondents were also concerned that the six month transition period was not long enough. In light of this, the Government has extended the timetable for adopting loss allocation arrangements for losses which arise other than as a result of member default. CCPs will be given nine months after the date the regulations come into force in which to implement these. For losses which arise as a result of member default this will stay the same, and industry will be given six months to put in place loss allocation arrangements. This reflects the reality that most CCPs already have voluntary loss allocation arrangements in place for losses that arise as a result of member default.

8.5 Some stakeholders also suggested that exposing clearing members to potentially unlimited liabilities risked damaging the international competitiveness of the UK. However, the loss allocation rules which are being implemented give the CCP, and its members, discretion over what these arrangements are. Therefore, the Government believes that it is possible for CCPs to establish loss allocation arrangements that satisfy regulatory expectations but do not expose members to unlimited liability. These are

already established with regard to several UK CCPs in the case of losses arising as a result of member default.

9. Guidance

9.1 The Treasury does not propose to produce any guidance in relation to the EMIR related aspects of these Regulations. ESMA and the competent authorities in the UK have the power to issue guidance in relation to EMIR and these Regulations and the Treasury considers it more appropriate that any such guidance is issued by them.

9.2 The Bank of England has issued guidance in relation to recovery plans and loss allocation arrangements in its publication "The Bank of England's approach to the supervision of financial market infrastructures"[1] (section 3.4) and currently has no plans to issue further guidance.

10. Impact

10.1 An Impact Assessment was conducted to evaluate the proposal to require CCPs to have in place loss allocation arrangements and recovery plans. The Impact Assessment concluded that the benefits of having these requirements in place would far exceed the likely costs of implementation. It also concluded that it would be more beneficial to introduce the requirements now rather than waiting for any similar legislation at a European level[2].

10.2 An Impact Assessment was not conducted for the changes relating to EMIR as the Regulations will not impose a cost on market participants. They are mechanical and legalistic in nature, making it easier for market participants to comply with EMIR. In terms of regulatory impact, the EMIR-related changes to the existing regulatory regime are no more or less onerous on market participants than the position existing before they are made, with many of the changes clarifying the existing legal and regulatory landscape.

10.3 The impact that this instrument has on charities and voluntary bodies is negligible.

10.4 The impact that this instrument has on the public sector is negligible.

11. Regulating small business

11.1 The legislation applies to small business.

11.2 There is no provision to minimise the impact of the requirements on small firms employing up to 20 people. EMIR does not provide any basis for excluding small or micro businesses from regulation. It is also undesirable to

[1] http://www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf
[2] https://www.gov.uk/government/consultations/financial-sector-resolution-broadening-the-regime

exempt smaller firms from EMIR as this would hinder its effectiveness, and run the risk of regulatory arbitrage based on firm size. Furthermore, the changes being introduced will benefit smaller businesses that participate in indirect clearing.

11.3 Regarding proposals related to EMIR, there was no formal consultation of market participants, other than informal consultation throughout negotiations with market participants on the European Commission's proposals for EMIR, including a number of round table meetings, as well as the European Commission's public consultation which informed EMIR's proposals. Therefore, the Treasury did not formally consult with small firms on possible exemptions for small businesses; such an exemption would not be possible due to the direct applicability of EMIR.

11.4 With regard to the proposed changes to recognition requirements to make loss allocation and recovery plans mandatory, no small businesses are directly affected as none are recognised clearing houses. In any case, no firm should be exempted from the requirements as this could pose a risk to financial stability if an exempted firm were to incur sufficiently heavy losses.

12. Monitoring & review

12.1 The Treasury is required to review the operation and effect of the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013, which these Regulations amend, within a five year period after the Regulations come into force and within every five years after that. That review will consider the amendments made to Part 7 of the Companies Act 1989 by those Regulations, and will consider the further amendments made by these Regulations. The transitory provision will have ceased to have effect by the time of any review, so it is considered unnecessary to include a formal review provision.

12.2 Under Article 85 of EMIR the Commission is required to review and prepare a general report on EMIR and submit that report together with any appropriate proposals to the European Parliament and Council by 17 August 2015.

13. Contact

Ola Ajadi at the Treasury, telephone: 020 7270 5912 or email: ola.ajadi@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.