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FIA EUROPE – 305 OPINIONS PROJECT
CM legal opinion

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1 July 2014

Dear Sirs,

Clearing Member Opinion issued in relation to England and Wales

You have asked us to give an opinion in respect of the laws of England and Wales ("**this jurisdiction**") in relation to clearing services provided by a person (a "**Clearing Member**") through a central counterparty (the "**CCP**") incorporated in any EEA jurisdiction, including but not limited to this jurisdiction, which has been authorised for the purposes of article 14 of Regulation (EU) No 648/2012 ("**EMIR**").

We understand that your fundamental requirement arises under article 305(2)(c) of Regulation (EU) No 575/2013 (the "**CRR**"), which requires that an institution has available a written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and authorities would find that the client would bear no losses on account of the insolvency of its clearing member or of any of its clearing member's clients under the laws of certain jurisdictions (the "**Opinion Issue**").

This Memorandum relates to the CCP-related transactions (as defined in article 300(2) of the CRR) which the Client has with the Clearing Member. In this context, we understand the CRR to provide a lower risk-weighting, by virtue of article 305(2) of the CRR, in respect of that portion of the Client's exposure to the Clearing Member which (a) comprises CCP-related transactions and (b) would not be subject to losses on account of the insolvency of the Clearing Member or the Clearing Member's other clients.

As to the various systems of law under which analysis is required, we refer you to paragraph 3 of this Memorandum.

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1. CONTENT

The layout of this Memorandum of law is as follows.

Introduction and orientation

- Terms of reference (para 2)
- Relevance of the laws of other jurisdictions (para 3)
- Material assumptions (para 4)
- Insolvency procedures applicable to the Clearing Member (para 5)
- Effect of insolvency laws in default scenario (para 6)

Analysis of protection given to Client

- Segregation and bankruptcy remoteness of Client positions and assets (para 7)
- Transfer of Client's positions and assets to a replacement clearing member (para 8)
- Close-out of positions (para 9)

Conclusions

- Conclusions as to whether Client would "bear no losses" (para 10).

2. TERMS OF REFERENCE

2.1 *Scope*

For the purposes of this Memorandum, a "**Client**" is a "client" as defined in article 300(4) of CRR who has entered into an arrangement with a Clearing Member for the clearing of transactions entered into by or on behalf of the Client. Other clients of the Clearing Member are referred to as "**other clients**".

This Memorandum applies in respect of a Clearing Member who carries out the role defined in article 300(2) of the CRR, and which is:

- a person incorporated in England and Wales under the Companies Acts which has permission to accept deposits by virtue of Part 4A of FSMA (an "**English Bank**");
- a person incorporated in England and Wales under the Companies Acts (whether or not an English Bank) which qualifies under section 232 of the Banking Act 2009 as an "investment bank" (an "**English Investment Bank**");
- a branch in England and Wales of a bank incorporated or organised in an EEA member state other than the United Kingdom (an "**EEA Bank**");
- a branch in England and Wales of an investment firm incorporated or organised in an EEA member state other than the United Kingdom (an "**EEA Investment Firm**"); or

- a branch in England and Wales of a bank incorporated or organised in a country or territory outside the EEA (a "**Third Country Bank**").

In relation to a Clearing Member which is an EEA Bank, an EEA Investment Firm, or a Third Country Bank, this Memorandum applies only in relation to clearing services provided in this jurisdiction in relation to a CCP incorporated in this jurisdiction.

2.2 *Account structure, transactions and collateral*

This Memorandum applies where the Client has elected for "individual client segregation" for the purposes of article 39(3) of EMIR in relation to its contracts cleared at the CCP.

This Memorandum applies in respect of the Client's CCP-related transactions. This Memorandum is not limited in respect of the types of contract cleared on behalf of a particular Client at the CCP as at the date of this Memorandum, except that this Memorandum does not cover any contracts cleared at the CCP which are not of a type referred to in article 301(1) of the CRR or any clearing service provided by the CCP which (a) operates on the basis of the Clearing Member acting for any purpose as agent, or (b) involves interoperability between the CCP and another central counterparty.

This Memorandum also applies in respect of collateral[1] which comprises either cash provided in a currency that is freely transferable internationally under the laws of all relevant jurisdictions or freely transferable securities in book-entry form, which has been provided in respect of the Client's CCP-related transactions:

- on a title-transfer basis to the Clearing Member, or under a security interest in circumstances where the Clearing Member has exercised an unconditional right of use; or

- to the CCP as Security Interest Collateral.

In relation to a Clearing Member which is an EEA Bank, EEA Investment Firm or Third Country Bank, this Memorandum is limited to the analysis of cash or securities credited to a securities account, provided on the books of the CCP or the Clearing Member as the case may be, located in this jurisdiction.

We assume that all necessary perfection steps have been taken in all relevant jurisdictions in respect of any collateral provided under a security interest.

2.3 *Definitions*

In this Memorandum the following terms have the following meanings:

"**Account**" means an individually segregated client account opened with the CCP in respect of the Client in conformity with article 39(3) of EMIR.

[1] CCPs may be entitled to accept gold as eligible collateral under EMIR. Gold is not within the scope of this Memorandum.

"**CCP-related transactions**" has the meaning ascribed to such term in article 300(2) of the CRR, being contracts or transactions falling within the scope of article 301(1) of the CRR between the Client and the Clearing Member that are directly related to contracts or transactions between the Clearing Member and the CCP.

"**Client Money Firm**" means an English Investment Bank which is not an English Bank.

"**Client Money Rules**" means the client money rules contained in the FCA Rules.

"**Client's positions and assets at the CCP level**" means the Client's claim in respect of obligations of the CCP owed to the Clearing Member as constituted by (i) the claims of the Clearing Member in respect of the Account and (ii) the entitlement of the Client to any Security Interest Collateral.

"**Client's positions and assets at the Clearing Member level**" means (i) the contractual obligations and entitlements of the Client in respect of the Clearing Member relating to CCP-related transactions and margin transferred to or by the Client on a title-transfer basis; and (ii) claims of the Client against the Clearing Member in respect of collateral assets delivered (other than on a title transfer basis) to the Clearing Member by the Client (and held and not returned by the Clearing Member at the relevant time).

"**Credit Institutions Regulations**" means the Credit Institutions (Reorganisation and Winding Up) Regulations 2004.

"**Documents**" means the documentation between the Client and the Clearing Member, including without limitation any FOA Netting Agreement, FOA Clearing Module, ISDA Master Agreement, ISDA/FOA Clearing Addendum, collateral agreement, or confirmation related to an individual CCP-related transaction.

"**EEA Credit Institution**" means an EEA credit institution as defined in the Credit Institutions Regulations, which means an EEA undertaking which qualifies as a credit institution under Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms but which is not a UK credit institution.

"**EMIR**" means Regulation (EU) No. 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories.

"**FCA**" means the Financial Conduct Authority.

"**FCA Rules**" means the FCA's Handbook of rules and guidance.

"**Financial Collateral Regulations**" means the Financial Collateral Arrangements (No. 2) Regulations 2003.

"**FSMA**" means the Financial Services and Markets Act 2000.

"**Insolvency Proceedings**" means the procedures listed in paragraph 5.1.

"**Investment Bank Regulations**" means the Investment Bank Special Administration Regulations 2011.

"**Part 7**" means Part 7 of the Companies Act 1989.

"**Party**" means the Client or the Clearing Member and "**Parties**" means both of them.

"**PRA**" means the Prudential Regulation Authority.

"**Recognition Requirements Regulations**" means the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001.

"**Rules**" means the rules, default rules, procedures, by-laws and other arrangements of the CCP binding on its clearing members.

"**Security Interest Collateral**" means securities collateral provided to the CCP as margin in respect of the Client's Account in respect of which the Client retains (subject to the CCP's right to realise the collateral upon due enforcement of a security interest) full ownership in the collateral.

"**Settlement Finality Regulations**" means the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

"**SISO**" means statutory insolvency set-off, as described in paragraph 6.3.2.

"**SISO Effective Date**" means:

(a) in respect of any SISO which takes effect pursuant to rule 4.90 of the Insolvency Rules 1986, the date on which a winding up order is made in respect of the Clearing Member;

(b) in respect of any SISO which takes effect pursuant to rule 2.85 of the Insolvency Rules 1986, the date on which the administrator gives notice under Rule 2.95 of the Insolvency Rules 1986 of a proposed distribution;

(c) in respect of any SISO which takes effect pursuant to rule 72 of the Bank Insolvency (England and Wales) Rules 2009, the date on which a winding up order is made in respect of the Clearing Member; or

(d) in respect of any SISO which takes effect pursuant to rule 164 of the Investment Bank Special Administration (England and Wales) Rules 2011, the date on which the administrator gives notice under rule 175 of the Investment Bank Special Administration (England and Wales) Rules 2011 of a proposed distribution.

"**UK bank**" means an undertaking incorporated in or formed under the law of any part of the United Kingdom and having its head office in the United Kingdom, which has permission under Part 4A of FSMA to accept deposits. For the purposes of this memorandum, all English Banks will be UK banks.

"**UK investment bank**" means an undertaking to which the Investment Bank Regulations apply (being, broadly, an institution which is incorporated in the United Kingdom, authorised under FSMA to safeguard and administer investments or deal in investments as principal or agent, and holds assets for clients). For the purposes of this Memorandum, all English Investment Banks will be UK investment banks.

Further terms used throughout this Memorandum are explained in paragraph 2.4.

In this Memorandum the following rules of interpretation shall apply:

References to "paragraphs" are to paragraphs of this Memorandum.

References to any legislation (whether primary legislation or regulations or other subsidiary legislation made pursuant to primary legislation) shall be construed as a reference to such legislation as the same may have been amended or re-enacted on or before the date of this Memorandum.

2.4 *Interpretation of the CRR*

For the purposes of this Memorandum, the following concepts used in article 305 of the CRR are understood by us to be appropriately interpreted as follows:

"**bankruptcy remote**" is defined in article 300(1) of the CRR as follows. "'Bankruptcy remote', in relation to client assets, means that effective arrangements exist which ensure that those assets will not be available to the creditors of a CCP or of a clearing member in the event of the insolvency of that CCP or clearing member respectively, or that the assets will not be available to the clearing member to cover losses it incurred following the default of a client or clients other than those that provided those assets." We understand that in the context of article 305 of the CRR it is not necessary to consider the effect of an insolvency procedure or reorganisation measures in respect of the CCP.

"**bear no losses**" is not defined in the CRR. We understand that the phrase means that in the event of the insolvency of the Clearing Member or one of its other clients, the Client's positions and assets at the Clearing Member level would neither be diminished nor rendered unenforceable as a result of the insolvency of the Clearing Member or its other clients. In this regard we would make the following observations:

(a) The requirement to show that the Client would bear no losses arises in the context of paragraphs (a) and (b) of article 305(2) of the CRR. Those paragraphs refer to the client's positions and assets related to CCP-related transactions. Our analysis in this Memorandum relates to "the Client's positions and assets at the Clearing Member level", namely the portion of the Client's exposure to the Clearing Member which corresponds to the Client's positions and assets at the CCP level.

(b) A relevant "loss" for the purposes of article 305(2) would thus arise where the insolvency of the Clearing Member has the effect that the Client can no longer rely on the value of the Client's positions and assets at the CCP level as a source of recovery in respect of its exposure to the Clearing Member constituted by the Client's positions and assets at the Clearing Member level.

(c) The relationship between the Client and the Clearing Member may involve more than a simple pass-through to the CCP of collateral provided by the Client to the Clearing Member. Notwithstanding that the Client may have other exposures to the Clearing Member which are referable to the clearing relationship, such as the provision of collateral in connection with a collateral transformation service, it is not necessary to assess the potential for losses arising from such arrangements, since, in our opinion, article 305(2) applies only to the portion of the Client's exposure to the Clearing Member which reflects the Client's positions and assets at the CCP level. Additional exposures arising from such arrangements would not benefit from the risk-weighting treatment of article 305(3) of the CRR.

(d) Article 5(2) of the CRR defines "loss" for the purposes of Part Three, Title II of the CRR (which includes article 305) as "economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument", and we have borne that in mind in giving our interpretation.

(e) The value of the Client's positions and assets at the CM level might be diminished or rendered unenforceable as a result of other causes, including, without limitation, market risk, valuation, custody risk (where the assets are held in the custody of a person other than the Clearing Member), delays in enforcement or other costs such as expenses of enforcement of security, or implementation of a regime for recalculation of amounts payable by the CCP, or service closure by the CCP. In our view, such issues are understood not to give rise to relevant "losses" as they do not constitute losses in respect of the Client's positions and assets at the Clearing Member level.

"**segregated**" is not defined in the CRR. For the purposes of this Memorandum, we understand that "segregated" has the meaning given to "individual client segregation" as explicated in article 39(4) of EMIR (and, so far as is relevant, article 39(9) of EMIR), which requires that the assets and positions held for the account of a client be distinguished from those held for the account of the relevant Clearing Member and its other clients. These requirements reflect those for "individual client segregation" at the CCP level as explicated in article 39(3) of EMIR. This common scope of segregation at the Clearing Member level and at the CCP level supports the approach of treating the exposures in respect of the Client's positions and assets at both such levels as corresponding to one another.

3. RELEVANCE OF THE LAWS OF OTHER JURISDICTIONS

3.1 Article 305(2)(c) of the CRR identifies which laws are considered to be relevant for the purposes of an analysis of whether a client would "bear no losses" in the context of a particular client clearing arrangement. Accordingly, this Memorandum is given in relation to English law as:

3.1.1 The law applicable to the jurisdiction of the Clearing Member. In the event of default of a Clearing Member, the courts of this jurisdiction would have jurisdiction to open insolvency proceedings in relation to an English Bank, an English Investment Bank, and a Third Country Bank, but not an EEA Bank, as

more particularly explained in paragraph 5.5. Furthermore, an English Bank, an English Investment Bank and a Third Country Bank will be subject to relevant provisions of the FCA Rules, which are governed by the laws of this jurisdiction.

3.1.2 The law governing the Client's collateral as provided to the Clearing Member. We understand that, for the purposes of the CRR, the law governing the collateral means the law applicable to the Client's entitlement to the collateral. In respect of cash collateral, under the laws of this jurisdiction the Client's entitlement to cash collateral will fall into one of the following categories:

(a) a contractual claim against the Clearing Member, which may be governed by English law. However, insofar as that claim is not governed by English law, the mechanisms which ensure the effective transfer to a replacement clearing member, or the effective payment to or for the account of the Client in relation to a close-out, are protected by statute and do not depend on the contracts concerned.

(b) in relation to a Client Money Firm, a proprietary claim under the Client Money Rules, which the claim would be governed by English law being the governing law of the Client Money Rules. However, to the extent that the client money in question is held in another jurisdiction, that additional system of law may also apply.

(c) in relation to an EEA Bank or an EEA Investment Firm, a proprietary or other type of claim under the client money rules of the Clearing Member's jurisdiction.

In respect of securities collateral which is transferred on a title transfer basis, the Client's entitlement will be a contractual claim against the Clearing Member, in relation to which the analysis at (a) above will apply. In relation to Security Interest Collateral at the CCP, under the conflicts of laws rules of this jurisdiction the law applicable to the client's entitlement would be:

- insofar as the collateral arrangement is a financial collateral arrangement under the Financial Collateral Regulations, the law of the place where the relevant account is maintained; and

- in other cases, the law of the place where the collateral is deemed to be located. There is appellate court authority (*Macmillan Inc v. Bishopsgate Investment Trust PLC (No.3)* [1996] 1 WLR 387) which can be interpreted as deciding that the place where shares are located is deemed to be the place where the share register is kept or the place where the issuer of the shares is incorporated, notwithstanding that the holder's interest in the shares is evidenced by book entries maintained by an intermediary.

3.2 This Memorandum does not address matters which may be relevant to the Opinion Issue and which arise under any of the following systems of law:

3.2.1 The law applicable to the jurisdiction of the CCP.

3.2.2 The law governing the arrangements for a transfer of the Client's positions and assets in the event of default of a Clearing Member.

3.3 Under the conflicts of laws rules of this jurisdiction, it would make no difference to the conclusions expressed in this Memorandum even if, under the laws of any of the following jurisdictions it would be legally possible for a person other than the Client to assert a claim to the Client's positions and assets at the CCP level, the Client's positions and assets at the Clearing Member level, or to challenge the manner in which any of them may be dealt with in the event of default of the Clearing Member or another client:

3.3.1 The law governing the CCP-related transactions.

3.3.2 The law applicable to the jurisdiction of the Client.

As a matter of English law, none of the questions which are material to a transfer or a close-out of the Client's positions and assets would be determined under the laws of such jurisdictions. In particular, in relation to the law governing the CCP-related transactions, the mechanisms which ensure the effective transfer to a replacement clearing member, or the effective payment or transfer to the Client in relation to a close-out, are protected by statute and do not depend on the contracts concerned. Accordingly the laws of this jurisdiction would not recognise or give effect to any law applicable to the Client which purported to interfere with the Client's rights against the Clearing Member or CCP or which purported to have any bearing on the question whether the Client would bear losses on account of the Clearing Member's insolvency or the insolvency of any other clients.

3.4 This Memorandum covers the effect of the regulatory framework and insolvency laws of this jurisdiction in respect of a Clearing Member in relation to the CCP-related transactions, regardless of the particular CCP. This Memorandum does not address specific matters which may affect the Opinion Issue under the insolvency laws of the jurisdiction of the CCP, even where the applicable insolvency laws are the laws of England. Regard should be had to a separate Memorandum of law of the jurisdiction of the CCP in respect of such specific matters.

4. MATERIAL ASSUMPTIONS

4.1 The opinions expressed in this Memorandum are based on the following assumptions.

4.1.1 That there is nothing in the Documents or other arrangements in existence between the Clearing Member and the Client for the clearing of transactions which is inconsistent with the arrangements under the Rules for the clearing, close-out and/or transfer upon default of the Clearing Member of the Client's positions and assets at the CCP level.

4.1.2 That the CCP has been authorised by the competent authority for the purposes of article 14 of EMIR, designated for the purposes of Directive 98/26/EC (the Settlement Finality Directive), and is not itself, at any material time, in default or subject to winding-up proceedings, reorganisation measures or any special resolution regime under the laws of any jurisdiction, and has not, at any

material time, implemented a service closure regime in respect of the clearing service to which the Client's Account relates.

4.1.3 That the Client is not itself, at any material time, subject to winding-up proceedings, reorganisation measures or any special resolution regime in any jurisdiction.

4.1.4 That all dealings between the CCP and the Clearing Member, and between the Clearing Member and the Client, are on a principal-to-principal basis.

4.1.5 That the Clearing Member has duly established an Account for the Client at the CCP in conformity with, and has complied with its other obligations under, article 39 of EMIR.

4.1.6 That the CCP will take action under its default rules and processes established for the purposes of article 48 of EMIR in the event of Insolvency Proceedings in respect of the Clearing Member.

4.1.7 That the Parties have entered into all appropriate Documents which are (a) prescribed by the CCP in order to give effect to a transfer to a replacement clearing member of the Client's positions and assets at the CCP and to a payment or transfer of assets to the Client for the purposes of article 48(7) of EMIR, and (b) otherwise necessary to provide for the clearing of the Client's CCP-related transactions and the collection and re-transfer of associated margin; that the Documents are legal, valid, binding and enforceable; and that the Documents do not contain any provisions which are inconsistent with the effective operation of the Rules and other arrangements intended to facilitate such a transfer to a replacement clearing member or such a payment or transfer of assets to the Client.

5. INSOLVENCY PROCEEDINGS APPLICABLE

5.1 The only bankruptcy, composition, rehabilitation or other insolvency or reorganisation procedures to which a Clearing Member could be subject under the laws of this jurisdiction, and which are relevant for the purposes of this Memorandum, are liquidation (including provisional liquidation), administration, bank insolvency, bank administration, investment bank special administration, special administration (bank insolvency), special administration (bank administration), administrative receivership, receivership, voluntary arrangements and schemes of arrangement.[2]

5.2 The legislation applicable to such Insolvency Proceedings is:

5.2.1 the provisions of the Insolvency Act 1986 and the Insolvency Rules 1986;

5.2.2 in relation to schemes of arrangement, sections 895 to 901 of the Companies Act 2006;

[2] Note, a proposed special resolution regime for certain investment firms, banking group companies and central counter parties is expected to be introduced in 2014.

5.2.3 in relation to an English Bank, the Banking Act 2009, the Bank Insolvency (England and Wales) Rules 2009, the Bank Administration (England and Wales) Rules 2009 and the Banking Act 2009 (Restrictions of Partial Property Transfers) Order 2009;

5.2.4 in relation to an English Investment Bank, the Investment Bank Regulations and the Investment Bank Special Administration (England and Wales) Rules 2011;

5.2.5 in relation to an EEA Bank or an English Bank, the Credit Institutions Regulations; and

5.2.6 in relation to an English Investment Bank which is not an English Bank, and in relation to an EEA Investment Firm, the Cross-Border Insolvency Regulations 2006.

In relation to an obligation which is a transfer order as defined in the Settlement Finality Regulations, the Settlement Finality Regulations will also be applicable. If the provision of collateral under the Documents constitutes a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms part, the Financial Collateral Regulations will also apply. Furthermore, the EU Insolvency Regulation has direct effect in this jurisdiction.

5.3 However, subject to the EU Insolvency Regulation and section 426 of the Insolvency Act 1986:

5.3.1 a foreign company may not enter administration or make a voluntary arrangement unless it is incorporated in an EEA member state, or has its centre of main interests in an EU member state (other than the United Kingdom or Denmark);

5.3.2 administrative receivership is not available in respect of a foreign company, with the possible exception of foreign companies which have registered particulars under the Overseas Companies Regulations 2009;

5.3.3 bank insolvency and bank administration are procedures only available in respect of a UK bank;

5.3.4 investment bank special administration is a procedure only available in respect of a UK investment bank which is not a deposit-taking bank with eligible depositors, special administration (bank administration) is a procedure only available in respect of a UK investment bank which is a deposit-taking bank and special administration (bank insolvency) is a procedure only available in respect of a UK investment bank which is a deposit-taking bank with eligible depositors; for these purposes, "*eligible depositors*" has the meaning given in section 93(3) of the Banking Act 2009, being, broadly, depositors who are eligible for compensation under the Financial Services Compensation Scheme; and

5.3.5 in relation to an EEA Credit Institution, liquidation (including provisional liquidation), administration and voluntary arrangements are not available; and

a scheme of arrangement in relation to an EEA Credit Institution which is, broadly, intended to enable it to survive, but affects creditors' rights, or to enable its assets to be realised and distributed to creditors, may not be sanctioned by the court unless the relevant insolvency officer or administrative or judicial authority (which would usually be the officer or authority of the EEA Credit Institution's home state) has been notified and has not objected.

5.4 Instead of, or in addition to, Insolvency Proceedings, if the Clearing Member has permission under Part 4 of FSMA to carry on the regulated activity of accepting deposits, the Clearing Member will satisfy the definition of a "bank" under section 2 of the Banking Act 2009 and may therefore be subject to a "property transfer instrument" under sections 11 and 12 of that Act if the PRA is satisfied that the Clearing Member is failing, or likely to fail, to satisfy the threshold conditions for authorisation under section 55B of FSMA.

5.5 In consequence of the foregoing, the following Insolvency Proceedings are available in this jurisdiction to the following types of Clearing Member:

5.5.1 English Banks and English Investment Banks: liquidation (including provisional liquidation), administration, bank insolvency, bank administration, investment bank special administration, special administration (bank insolvency), special administration (bank administration), administrative receivership, receivership, voluntary arrangements and schemes of arrangement, and the special resolution procedures under the Banking Act 2009.

5.5.2 EEA Banks: English courts have no relevant jurisdiction.

5.5.3 EEA Investment Firms: on the assumption that the Clearing Member provides services involving the holding of funds or securities for third parties, liquidation (including provisional liquidation), administration, receivership, voluntary arrangements and schemes of arrangement.

5.5.4 Third Country Banks: liquidation (including provisional liquidation) and schemes of arrangement only.

6. EFFECT OF INSOLVENCY LAWS IN DEFAULT SCENARIO

Insolvency law challenges theoretically available under English law

6.1 Various powers are given to an insolvency officer under the Insolvency Act 1986 which could (absent special statutory protection) affect the ability of the Client to effect full recovery from the Clearing Member in respect of its positions and assets. These are, insofar as relevant to the circumstances, described in the following paragraphs, after which the defences and protections available are discussed.

6.1.1 *Section 127 (avoidance of property dispositions, etc.)*

In a winding-up by the courts under the laws of this jurisdiction or a bank insolvency, any dispositions of a company's property made after the commencement of winding-

up or bank insolvency of the company are void under section 127 of the Insolvency Act 1986 unless the court otherwise orders.

6.1.2 *Section 178 (power to disclaim onerous property)*

Under this section of the Insolvency Act 1986, the liquidator may, by the giving of the prescribed notice, disclaim any onerous property of the insolvency company and may do so notwithstanding that he has taken possession of it, endeavoured to sell it, or otherwise exercised rights of ownership in relation to it. For these purposes, "onerous property" comprises any unprofitable contract, and any other property of the company which is unsellable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.

6.1.3 *Section 186 (rescission of contracts by the court)*

The court may, on the application of a person who is, as against the liquidator, entitled to the benefit or subject to the burden of a contract made with the company, make an order rescinding the contract on such terms as to payment by or to either party of damages for the non-performance of the contract, or otherwise as the court thinks just. Any damages payable under the order to such a person may be proved by him as a debt in the winding up.

6.1.4 *Section 238 (transactions at an undervalue)*

Under section 238 of the Insolvency Act 1986, a transaction entered into by a company at any time within a specified period ending with the onset of insolvency of the company (being, in broad terms, the earliest of: the date of initiation of proceedings for administration, liquidation or winding-up; or the date of the company entering administration) with a person on terms that provide for the company to receive either no consideration, or consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by it, may be set aside as a transaction at an undervalue, if at the time the transaction is entered into that company was unable to pay its debts or became unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986 in consequence of the transaction. A court would not set aside such a transaction if it were satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business and that at the time it did so there were reasonable grounds for the belief that it would benefit the company.

6.1.5 *Section 239 (preferences)*

Under section 239 of the Insolvency Act 1986, anything done or suffered to be done by a company within a specified period ending with the onset of insolvency (as defined in paragraph 6.1.4) of that company may be set aside as a preference. The thing done or suffered will be liable to be set aside if at the time it was done or suffered that company was unable to pay its debts or became unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986 in consequence of the thing done or suffered and that thing has the effect of putting any person in a better position, in the event of that company going into insolvent liquidation, than that person would have been in if the thing had not been done or suffered. However, the court would not make such an order if it was satisfied that the company which gave

the preference was not influenced to give it by a desire to put that person in such better position.

6.1.6 *Section 244 (extortionate credit transactions)*

The court may, on the application of the office-holder, make an order with respect to the transaction if the transaction is or was extortionate and was entered into in the period of three years ending with the day on which the company entered administration or went into liquidation. A transaction would be "extortionate" if the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit, or it otherwise grossly contravened ordinary principles of fair dealing.

6.2 Furthermore, insofar as the Clearing Member has provided collateral to the CCP under a security interest in respect of the Account, the following issues may arise:

6.2.1 *Section 175 (preferential debts)*

Under section 175(2)(b) of the Insolvency Act 1986, the "preferential debts" of a company (which includes employee claims, certain pension liabilities and various other categories of claim outlined in Schedule 6 to the Insolvency Act 1986) have priority over the claims of floating charge holders. The holder of a fixed charge however, is not subject to this risk of priority loss.

6.2.2 *Section 176A (prescribed portion)*

Section 176A of the Insolvency Act 1986 creates a partial exception to the general rule that a secured creditor is entitled to receive the full value realized from the sale of secured assets, by obliging an insolvency officeholder, who realises the value of assets that are subject to a floating charge, to set aside some of that realised value to fund a distribution to the company's unsecured creditors, instead of the holder of the floating charge, thus diminishing the value of the latter's security and their recovery. The holder of a fixed charge however, is not subject to this risk.

6.2.3 *Section 176ZA (expenses)*

Under section 176ZA of the Insolvency Act 1986, winding up expenses have priority over the claims of floating charge holders where the assets of the company available for payment of general creditors are insufficient for such purposes.

6.2.4 *Section 245 (voidable floating charges)*

Section 245 of the Insolvency Act 1986 invalidates all floating charges on the company's undertaking or property created at a relevant time, such relevant time being: (i) in respect of a charge created in favour of a connected person, the period of two years ending with the onset of insolvency (as defined in paragraph 6.1.4); (ii) in respect of a charge created in favour of a non-connected person, the period of twelve months ending with the onset of insolvency; (iii) the period between the time an administration application and the time an administration order in respect of the company is made; and (iv) the period between the time a notice of intention to appoint an administrator is filed and the time such appointment is made.

6.3 Under general principles of insolvency law in this jurisdiction, the following further issues could (absent special statutory protection) affect the ability of the Client to effect full recovery in respect of its positions and assets. These are, insofar as relevant to the circumstances:

6.3.1 *Anti-deprivation rule*

The "anti-deprivation" rule, which provides that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors..." (*Ex parte Jay, 1880*). Modern authorities indicate that the rule is essentially based on the proposition that a person may not contract out of the provisions of the insolvency legislation which determine how assets are dealt with in insolvency, the basic premise for which is that they should be liquidated and shared out *pro rata* among creditors ranking *pari passu*. The removal from the estate of a Clearing Member of its claim against a CCP or against a Client could be seen as a contravention of the anti-deprivation rule.

6.3.2 *Statutory insolvency set-off*

A statutory insolvency set-off ("**SISO**") may be implemented:

(a) in a winding-up, under rule 4.90 of the Insolvency Rules 1986;

(b) in an administration, under rule 2.85 of the Insolvency Rules 1986;

(c) in a bank insolvency, under rule 72 of the Bank Insolvency (England and Wales) Rules 2009;

(d) in a bank administration, under rule 2.85 as applied by the Bank Administration (England and Wales) Rules 2009; and

(e) in relation to an investment bank special administration, a special administration (bank insolvency) or a special administration (bank administration), under rule 164 of the Investment Bank Special Administration (England and Wales) Rules 2011.

SISO is mandatory in respect of all mutual amounts due between the person subject to such Insolvency Proceedings and a creditor of that person.

6.4 The Banking Act 2009[3] contains various provisions which could (absent special statutory protection) affect the ability of the Client to effect full recovery in respect of its positions and assets. In particular, Part 1 of the Banking Act 2009 provides for various remedies in respect of a failing UK bank, which include the ability of the Treasury or the Bank of England to cause the transfer of securities issued by a UK

[3] The UK is expected to commence already adopted (but not yet operative) provisions that may extend the entity scope of UK special resolution powers beyond 'banks' to certain categories of systemically important investment firm, as well as introducing new resolution tools, such as bail in powers. These changes to the UK special resolution regime for banks and investment banks would not fundamentally impact our analysis for the purposes of article 305 though may require further analysis.

bank, or property of a UK bank, to another person, by means of a "share transfer order", a "share transfer instrument", or a "property transfer instrument".

Section 75 of the Banking Act 2009 gives the Treasury the power to change the law (except the Banking Act 2009 itself) for the purpose of enabling the powers granted to the PRA, the Treasury and the Bank of England under Part 1 of the Banking Act 2009 to be used effectively. Such changes might affect private law rights and might be used with retrospective effect. Furthermore, under sections 23 and 40, a share transfer instrument or order, or a property transfer instrument, may include incidental, consequential or transitional provisions which might have an impact on private law rights.

A property transfer instrument may apply to only part of a UK bank's property, rights and liabilities (such a transfer being referred to as a "partial property transfer"). This may be the case because the property transfer instrument concerned expressly applies to only part of the UK bank's business or because it is ineffective in relation to foreign property. A partial property transfer could take effect so as to cause the transfer of some, but not all, of the Client's positions and assets at the CCP level to another person which could be different from the replacement clearing member proposed by the Client, with the result that the netting of the Client's positions is undermined and/or that the Client's positions are under-collateralised. (A partial property transfer of the Client's positions and assets at the Clearing Member level would not per se affect entitlement to the Client's positions and assets at the CCP level, and so would not give rise to any losses relevant for the purposes of this Memorandum.)

6.5 The FCA Rules[4], which have the force of law in this jurisdiction, provide for the disposition of client money and client assets upon default or insolvency of an authorised person (which would include Clearing Members which are English Banks, English Investment Banks, and Third Country Banks). In relation to each of these:

6.5.1 As regards cash received by an English Bank or a Third Country Bank, there are exemptions available which disapply the Client Money Rules where the cash received by the Clearing Member is provided under a title transfer collateral arrangement or as a deposit. We assume for the purposes of this Memorandum that one or other of these exemptions applies to cash received by an English Bank or a Third Country Bank.

6.5.2 As regards cash received by a Client Money Firm, the Client Money Rules will apply except insofar as the cash received by the Clearing Member is provided under a title transfer collateral arrangement. The scheme of the Client Money Rules is that client money is held on trust by the Client Money Firm, and the client money therefore does not form part of the insolvent estate of the Client Money Firm. The Client Money Firm holds, as a trust asset, any receivable represented by passing the client money to a third party such as a

[4] The FCA has indicated that the Client Money Rules will be modified in various respects starting from December 2014. The changes will allow for separate client money pools, though these would relate to omnibus accounts rather than individually segregated accounts. The changes proposed would not affect the general conclusions expressed in this Memorandum.

CCP. Client money, or a claim against the CCP in respect of client money (which, in the circumstances, would include cash collateral passed to the CCP), will be subject to the distribution regime of the Client Money Rules in the event of a default by the Clearing Member which constitutes a "primary pooling event" under the Client Money Rules.

6.5.3 As regards cash or securities collateral received by English Banks, English Investment Banks, and Third Country Banks under a security interest, the FCA's client assets rules will apply, but no issues relevant for the purposes of this Memorandum arise under such FCA Rules.

6.5.4 As regards cash or securities collateral received by English Banks, English Investment Banks, and Third Country Banks on a title transfer basis, no relevant issues arise under the FCA Rules.

6.6 Notwithstanding the foregoing, provisions of insolvency law which might affect the ability of the Client to effect full recovery in respect of its positions and assets do not apply in a case where either of the special legal regimes for "market contracts" or for "designated systems" applies, or the safeguards in relation to partial property transfers under the Banking Act 2009 apply. These protections are outlined in the following paragraphs.

Protections under the Companies Act 1989

6.7 Under section 158(1) of the Companies Act 1989, the general law of insolvency is subordinated in various respects to the special legal regime for "market contracts" cleared at a recognised central counterparty, and by virtue of section 170A(2) of the Companies Act 1989, at an EEA central counterparty or a third country central counterparty. Insolvency law is expressly made subject to the provisions of section 159 of the Companies Act 1989 in relation to each of the following:

6.7.1 "market contracts";

6.7.2 action taken by the CCP under its Rules to transfer or settle "clearing member client contracts" in accordance with its default rules;

6.7.3 action taken to transfer "qualifying collateral arrangements" in conjunction with such a transfer of clearing member client contracts or client trades; and

6.7.4 "qualifying property transfers".

For these purposes, the terms between quotation marks should be interpreted as follows:

6.7.5 "market contracts" includes in respect of a central counterparty such as the CCP which is a "recognised central counterparty" for the purposes of section 285 FSMA and Part 7, clearing member client contracts (as described below);

6.7.6 "clearing member client contract" means, broadly, a contract between a recognised central counterparty and a clearing member which is recorded in

the accounts of the recognised central counterparty as a position held for the account of a client;

6.7.7 "client trade" means, broadly, a contract between a clearing member and a client which corresponds to a clearing member client contract;

6.7.8 "qualifying collateral arrangement" includes (a) an arrangement by which property is provided as margin and is recorded in the accounts of a recognised central counterparty as an asset held for the account of a client and (b) an arrangement by which margin is provided to a client or clearing member for the purpose of providing cover for exposures arising out of present or future client trades; and

6.7.9 "qualifying property transfer" means, broadly, (a) a transfer by a recognised central counterparty of property representing the balance of collateral held for the account of a client (i) to the relevant client, when known to the recognised central counterparty and otherwise (ii) to the relevant clearing member for the account of the relevant client; and (b) a transfer of property to a non-defaulting clearing member in accordance with the default rules of a recognised central counterparty, either by way of transferring the contracts and associated collateral or terminating and closing the relevant client contracts and establishing them with the non-defaulting clearing member and providing for a transfer of the relevant close-out value to such non-defaulting clearing member.

6.8 In accordance with section 159 of the Companies Act 1989, none of the following shall be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of the assets of a person on winding up or administration:

6.8.1 the rules of the CCP to give effect to the transfer or settlement of a clearing member client contract;

6.8.2 a transfer or settlement of a clearing member client contract in accordance with the CCP's default rules;

6.8.3 a transfer of a client trade or group of client trades corresponding to a clearing member client contract transferred in accordance with the CCP's default rules;

6.8.4 a transfer of a qualifying collateral arrangement in conjunction with such a transfer of clearing member client contracts or client trades; or

6.8.5 a qualifying property transfer.

In addition, the powers of an insolvency office-holder and the powers of the court under the Insolvency Act 1986 and parts 2 and 3 of the Banking Act 2009 shall not be exercised in such a way as to prevent or interfere with those things.

In relation to a transfer of a clearing member client contract cleared at an EEA central counterparty or a third country central counterparty, the protection granted from

interference by an insolvency office-holder or the court is subject to the minor limitation described in paragraph 8.2.

The protections summarised in this paragraph are referred to as "**Part 7 Protections**".

6.9 For the purposes of the Part 7 Protections, the "law of insolvency" includes, according to section 190(6) of the Companies Act 1989, every provision made by or under the Insolvency Act 1986. The Part 7 Protections also specifically disallow certain challenges under the Insolvency Act 1986, notably under sections 127, 178, 186, 238 and 239, and (under section 182A of the Companies Act 1989) prohibit the set-off of positions and assets recorded in an account at a CCP and held for the account of a Client in accordance with article 39 of EMIR against positions and assets recorded in any other account at the CCP.

Protections under the Settlement Finality Regulations

6.10 In addition, under regulation 13 of the Settlement Finality Regulations, the general law of insolvency is subordinated in various respects to the special legal regime for "transfer orders" effected through a designated system. Insolvency law is expressly made subject to the provisions of regulation 14 of the Settlement Finality Regulations in relation to the default arrangements of a designated system and the rules of a designated system as to the settlement of transfer orders.

"Default arrangements" means the arrangements put in place by a designated system to limit systemic and other types of risk which arise in the event of a participant appearing to be unable, or likely to become unable, to meet its obligations in respect of a transfer order, including, for example, any default rules within the meaning of Part 7, and arrangements for netting, the closing out of open contracts, and the transfer of positions and/or assets on the default of a participant.

A "transfer order" is an instruction by a participant in a designated system to place at the disposal of an amount of money, or to transfer title to (or an interest in) securities by means of a book entry. Although the principal purpose of the Settlement Finality Regulations is the protection of transfer orders, we consider that the effect of the Settlement Finality Regulations is not so narrowly confined: regulations 14(1)(b) and 14(2)(b) of the Settlement Finality Regulations provide that the totality of default arrangements of a designated system take precedence over insolvency law, whether or not the default arrangements apply to "transfer orders", since transfer orders are separately and specifically dealt with in regulations 14(1)(a) and 14(2)(a).

6.11 Regulation 14 of the Settlement Finality Regulations states that the default arrangements of a designated system shall not be regarded as invalid at law on the ground of inconsistency with the law relating to the distribution of assets of a person on winding up or administration, or with the law relating to other insolvency proceedings of a country or territory outside the UK. Furthermore the powers of an insolvency office-holder and of the courts under the Insolvency Act 1986 shall not be exercised in such a way as to prevent or interfere with any action taken under the default arrangements of a designated system. In addition, regulation 25 of the Settlement Finality Regulations provides that no court in this jurisdiction shall recognise or give any effect to any order of a court exercising jurisdiction in relation

to insolvency laws in a country or territory outside the United Kingdom or any act of a person appointed in such a country or territory to discharge any functions under insolvency law to the extent that such order or act would be prohibited in the case of a court in this jurisdiction.

In relation to a CCP which is designated for the purposes of the Settlement Finality Directive in another Member State (an "**Overseas Designated System**"), regulation 26 of the Settlement Finality Regulations applies the protections of the Settlement Finality Regulations to "equivalent overseas orders" which are, in effect, transfer orders effected through the relevant CCP. In consequence, the protections available under regulation 26 of the Settlement Finality Regulations are more limited in scope than those available under regulation 14 of those Regulations and, notably, do not extend to the protection of the default arrangements of such an Overseas Designated System. However, in relation to any CCP which is an Overseas Designated System but which also qualifies as an EEA central counterparty for the purposes of Part 7, the Part 7 Protections would be available in respect of action taken by such CCP under its default rules to transfer or settle "clearing member client contracts" (as described in paragraph 6.8 of this Memorandum but subject to the minor limitation described in paragraph 8.2).

6.12 In relation to regulations 13 and 14 of the Settlement Finality Regulations, the Clearing Member would be a participant in a designated system.

6.13 For the purposes of the protections given under the Settlement Finality Regulations, the "law of insolvency" includes, according to regulation 2(2), every provision made by or under the Insolvency Act 1986. The Settlement Finality Regulations also specifically disallow certain challenges under the Insolvency Act 1986, notably under sections 127, 178, 186, 238 and 239.

6.14 We should mention that there is an argument, in the case of a CCP which clears a number of different products in distinct product-specific clearing services, that there would not be one single designated system for the purposes of the Settlement Finality Regulations (being the single centralised cross-product clearing system operated by the central counterparty) but, instead, the system in respect of each product cleared by the central counterparty should be treated as representing a separate designated system. If this were the case, then, notwithstanding our assumption at paragraph 4.1.2, and notwithstanding that the Bank of England (as the relevant "designating authority" under the Settlement Finality Regulations) has indicated on its website that the CCP as a whole constitutes a designated system, it may be that certain Services cleared by the CCP constitute or contain a designated system, whilst others do not. A possible consequence of this might be that, for certain Services, and for the contracts cleared on those Services, the protections provided under the Settlement Finality Regulations would not be available in respect of the relevant Services.

There is also an argument that amounts due under contracts which constitute derivatives do not constitute "transfer orders" for the purposes of the Settlement Finality Regulations. A "transfer order" may be either a "payment transfer order" or a "securities transfer order" (as defined in the Settlement Finality Regulations). While a cash sum due to be paid under a Contract which is a derivative ought to constitute, or give rise to, a "payment transfer order", it may be that the entirety of the contract

cannot properly be so regarded. Further, if under the terms of a Contract, title to, or an interest in, a commodity or other thing which is not a "security" (meaning an instrument referred to in section C of Annex I to Directive 2004/39/EC (MiFID)) is transferred, that contract would not appear to constitute a "transfer order". If those arguments were to prevail, the additional protections provided by the Settlement Finality Regulations which are mentioned above may not be available in respect of those contracts.

The provisions of the Settlement Finality Regulations referred to in this Memorandum will not apply in relation to any transfer order which is entered into the designated system (which we take to mean registered by the CCP) after the court has made a winding-up or administration order in relation to the Clearing Member or the Clearing Member has passed a resolution for creditors' voluntary winding-up, unless the transfer order is carried out on the same business day of the designated system as the winding-up order or resolution, or as the case may be administration order, and the CCP can show it did not have notice of the order or resolution.

Protection under the Safeguards Order

6.15 The Part 7 Protections and the Settlement Finality Regulations do not provide protection in relation to the potential consequences of a special resolution of a UK bank under Part 1 of the Banking Act 2009. However, certain protections are available under The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "**Safeguards Order**").

6.16 Article 7 of the Safeguards Order provides that a property transfer order may not transfer property, rights or liabilities to the extent that to do so would have the effect of modifying the operation of or rendering unenforceable the default rules of a recognised clearing house or the rules of a recognised clearing house as to the settlement of market contracts not dealt with under its default rules. For these purposes, only a CCP which has been granted recognition in the United Kingdom under section 285 of FSMA would qualify as a "recognised clearing house".

However, in relation to any other CCP, including a CCP which has been authorised in another Member State under article 17 of EMIR (and which would, therefore, be an "EEA central counterparty" in accordance with section 285(1)(c) of FSMA):

6.16.1 article 3 of the Safeguards Order prohibits a partial property transfer which applies to some, but not all, of the "protected rights and liabilities" between a particular person and a UK bank. "Protected rights and liabilities" means rights and liabilities which a party is entitled to set off or net under a set-off arrangement, netting arrangement or title transfer financial collateral arrangement, so long as they are not "excluded rights" or "excluded liabilities". For these purposes, transactions in derivatives which are cleared through a CCP should not be "excluded rights" or "excluded liabilities";

6.16.2 article 4 of the Safeguards Order prohibits a partial property transfer which would contravene EU law. Accordingly a partial property transfer could not take effect so as to frustrate the operation of a transfer of the Client's positions and assets at the CCP level to a replacement clearing member or the transfer of

a balance owed by the CCP to the Client, or to permit assets recorded in the Account to be exposed to losses connected to positions recorded in another account, all of which are results contrary to EMIR. Furthermore, a partial property transfer could not take effect so as to interfere with an outcome protected by Directive 2002/47/EC (the Financial Collateral Arrangements Directive) or Directive 98/26/EC (the Settlement Finality Directive);

6.16.3 article 5 of the Safeguards Order prohibits a partial property transfer which transfers the property or rights against which a liability is secured, or transfers the benefit of the security, unless both the liability and the benefit of the security are transferred. Accordingly, a partial property transfer cannot have effect to as to separate margin held for the account of the Client at the CCP in the form of Security Interest Collateral from the obligations which relate to the Client's Account.

Accordingly, the Safeguards Order protects the CCP against the adverse consequences of a partial property transfer affecting the Client's positions and assets at the CCP level, with the result that a partial property transfer affecting the Clearing Member would not give rise to any losses relevant for the purposes of this Memorandum.

Conclusions on availability of insolvency law challenges

6.17 In conclusion, the Part 7 Protections, the protections under the Settlement Finality Regulations and the Safeguards Order will provide a defence under the laws of this jurisdiction to challenges based upon the laws mentioned in paragraphs 6 to 6.5 inclusive. Further commentary is given at paragraphs 8.4 and 9.7 in relation to SISO and paragraphs 7.3 and 8.5 in relation to the Client Money Rules.

7. SEGREGATION AND BANKRUPTCY REMOTENESS OF CLIENT POSITIONS AND ASSETS

7.1 Insofar as the Rules of the CCP:

(a) provide that the positions and assets of the Client will be recorded in an account with the CCP which is separate from proprietary accounts of the Clearing Member and the accounts of other clients;

(b) do not permit the netting of positions and assets recorded on the Client's account against positions and assets recorded on accounts of the Clearing Member or other clients; and

(c) do not expose the positions and assets recorded in the Client's account to losses connected to positions and assets recorded in another account,

there are no rules of law of this jurisdiction which would apply so as to impair the effect of such Rules, subject to the observations set out in the remainder of this paragraph 7.

7.2 In the event of a SISO Effective Date applying to the Clearing Member, section 182A of the Companies Act 1989 will prevent the operation of SISO as between the CCP

and the Clearing Member causing the set-off of a sum due in respect of the Client's Account at the CCP against a sum due in respect of any other account at the CCP.

7.3 In relation to a Clearing Member which is a Client Money Firm, client money held in a client transaction account at an authorised central counterparty is excluded by FCA Rule CASS 7A.2.4R(1) from pooling upon a primary pooling event in respect of the Client Money Firm. A CCP which is authorised or recognised under EMIR is an "authorised central counterparty" for these purposes. Guidance in CASS 7A.2.4AG of the FCA Rules reflects the scheme of EMIR, namely to transfer client positions and assets where possible, and after the completion of the default management process to return any balance due to the Client or, where the Clients are not known to the CCP, to the Client Money Firm for the account of the Clients.

Where the Client Money Firm receives a remittance from a CCP in respect of an individual client account, under CASS 7A.2.4R(3)(a) it must be distributed to the relevant Client, but subject to CASS 7.7.2R(4), which states that the payment of costs properly attributable to the distribution of the client money are payable in priority to the interests of the Client.

7.4 In relation to any collateral transferred to the Clearing Member by the Client pursuant to a security interest, insofar as applicable the FCA Rules require, at CASS 6.2.1R, that the Clearing Member make adequate arrangements so as to safeguard Clients' ownership rights, especially in the event of the Clearing Member's insolvency. However, for the purposes of this Memorandum, we assume that the Clearing Member is complying with its obligation under article 39(6) of EMIR, so that collateral relating to the Client's CCP-related transactions will have been posted to the CCP, and any non-compliance by the Clearing Member with CASS 6.2.1R would not give rise to any losses relevant for the purposes of this Memorandum.

7.5 In relation to a Clearing Member which is an EEA Bank or an EEA Investment Firm, the Client Money Rules would not apply, and the regulatory rules of the Clearing Member's home state would apply to the holding of funds or financial instruments belonging to Clients. Under the laws of this jurisdiction a legal instrument which provides for the disposition of cash or securities (including a claim to a cash balance or other receivable) located in this jurisdiction which is valid under the relevant governing law and has been properly perfected in all relevant jurisdictions would be recognised in this jurisdiction, provided that there is no inherent restriction on alienation of any securities in question.

7.6 The Client's positions and assets at the CCP level would be "bankruptcy remote" in the event of the default or opening of insolvency proceedings in respect of the Clearing Member or one or more other clients. This is because effective arrangements exist which ensure that the Client's positions and assets at the CCP level (a) will not be available to the creditors of the Clearing Member in the event of the insolvency of the Clearing Member; and (b) will not be available to the Clearing Member to cover losses it may incur following the default of one or more other clients.[5]

[5] CRR article 300(1)

These conclusions apply whichever powers are exercised by the CCP on a default of the Clearing Member, as explained in the following paragraphs. Paragraph 8 addresses the exercise by the CCP of its powers to transfer the Client's positions and assets at the CCP level to a replacement Clearing Member, and paragraph 9 addresses the exercise by the CCP of its powers to close out the Client's positions and assets at the CCP level and to return any balance due in respect of the Account, and any unutilised collateral held by the CCP in respect of the Account to, or for the account of, the relevant Client.

8. TRANSFER OF CLIENT'S POSITIONS AND ASSETS

8.1 Insofar as the Rules of the CCP provide for the transfer of the Client's positions and assets to a replacement clearing member, there are no rules of law of this jurisdiction which would apply so as to impair the effect of such Rules.

8.2 In the event of Insolvency Proceedings relating to the Clearing Member, the Part 7 Protections would apply, so that action taken by the CCP to transfer the Client's positions and assets at the CCP level and the Client's positions and assets at the Clearing Member level would not be open to challenge in this jurisdiction under the law of insolvency.

In relation to an EEA central counterparty or a third country central counterparty, default rules relating to the transfer of positions or assets of a defaulting Clearing Member do not benefit from the Part 7 Protections if they are not necessary for the purposes of complying with the minimum requirements of articles 48(5) and (6) of EMIR, and do not satisfy the following four requirements laid down in paragraph 34(2) of the Recognition Requirements Regulations:

(a) the default rules must include a summary or a clear and prominent reference to how such summary may be accessed by the public, of how a transfer under the default rules will work and the primary legal implications;

(b) the default rules must ensure that a position or assets can only be transferred with the consent of the Client and the replacement clearing member;

(c) the default rules must ensure that transfers pursuant to them are fair to the Client; and

(d) the default rules must specify a pre-defined transfer period.

However, in our opinion an effective transfer which avoids losses for the Client would not rely on any Rules other than ones satisfying the requirements referred to in the preceding sentence, and the absence of the Part 7 Protections in relation to any Rules not satisfying the relevant requirements would not impair the effectiveness of the Part 7 Protections in relation to the Rules being relied upon.

8.3 Furthermore, in the event of Insolvency Proceedings relating to the Clearing Member, the Settlement Finality Regulations would apply to the extent described in paragraph 6.11 of this Memorandum, so that action taken by the CCP to transfer the Client's positions and assets at the CCP level, and the Client's positions and assets at the

Clearing Member level would not be open to challenge in this jurisdiction in a winding up or administration.

8.4 If a SISO Effective Date occurs in respect of the Clearing Member, there would be a mandatory statutory insolvency set-off of all amounts due between the Clearing Member and the Client, including all present and future amounts owed between the Clearing Member and the Client and any other present and future amounts owing between the Clearing Member and the Client so that only a single net sum is payable, notwithstanding the terms of any agreement between the Clearing Member and the Client. Under the laws of this jurisdiction it is not possible to contract out of SISO.

However, although section 182A of the Companies Act 1989 does not expressly disapply SISO as between the Clearing Member and the Client, SISO is clearly part of the "law of insolvency", and by virtue of sections 159(1)(f) and 158(1)(d) of the Companies Act 1989 the transfer of a "client trade" (which would include the Client's positions and assets at the Clearing Member level) may not be regarded as to any extent invalid on the ground of inconsistency with the law of insolvency. If the agreement between the Clearing Member and the Client makes no express provision for over-enrichment due to the operation of SISO in conjunction with a transfer of the Client's positions and assets at the Clearing Member level, the Clearing Member may (notwithstanding the purported terms of such agreement) be able to assert a claim for unjust enrichment (or equivalent under applicable law) to avoid the consequence of overpayment to Client, but this would not affect the validity of the transfer.

8.5 On the assumption that the Clearing Member has complied with its obligation under article 39(6) of EMIR, the Clearing Member should not have any collateral of the Client except in the course of onward transfer to the CCP. As regards the Client's positions and assets at the CCP level, Rule CASS 7A.2.4R(1) of the Client Money Rules excludes client money held in a client transaction account at an authorised central counterparty from the pooling arrangement applicable in the event of a primary pooling event occurring in respect of a Client Money Firm, and accordingly the Client Money Rules will not operate so as to impede the transfer of the Client's positions and assets at the CCP level to a replacement clearing member.

8.6 Insofar as the Rules or other arrangements effect a transfer of the Client's positions and assets at the Clearing Member level by means of a close-out of those contracts and re-establishment with a replacement clearing member, the considerations relevant to close-out discussed in paragraph 9 will apply.

8.7 Accordingly, the Client would not be subject to losses under the laws applicable to the insolvency of the Clearing Member in the event of a transfer of the Client's positions and assets at the CCP level.

9. CLOSE-OUT OF POSITIONS

9.1 Insofar as the Rules of the CCP provide for the close-out, netting, and application of collateral on the default of the Clearing Member, there are no rules of law of this jurisdiction which would apply so as to impair the effect of such Rules.

9.2 Insofar as the Rules of the CCP provide for the direct payment to the Client of an amount owing by the CCP following a close-out of the Client's positions and assets at

the CCP level, or the direct transfer to the Client of some or all of the Client's collateral at the CCP not utilised by the CCP in respect of losses arising on the Client's Account, there are no rules of law of this jurisdiction which would apply so as to impair the effect of such Rules.

9.3 In the event of Insolvency Proceedings relating to the Clearing Member, the Part 7 Protections would apply, so that action taken by the CCP to close out, net, apply collateral, and make a direct payment or transfer to the Client would not be open to challenge in this jurisdiction under the law of insolvency, or under parts 2 or 3 of the Banking Act 2009.

9.4 In the event of winding up or administration of the Clearing Member, the Settlement Finality Regulations would apply, so that action taken by the CCP to close out, net, apply collateral, and make a direct payment or transfer to the Client would not be open to challenge in this jurisdiction.

9.5 In the event of a partial property transfer under Part 1 of the Banking Act 2009, the Safeguards Order would operate so as to prevent the relevant transfer interfering with close-out netting or the application of collateral in respect of the Client's Account by the CCP or a close-out netting between the Clearing Member and the Client.

9.6 Article 48(7) of EMIR provides that any balance owed by the CCP after the completion of the Clearing Member's default management process by the CCP shall be readily returned to clients when the they are known to the CCP or, if they are not, to the Clearing Member for the account of its clients. If the CCP were to make a payment or transfer of assets to the Clearing Member under article 48(7), such payment or assets should be held outside the estate of the Clearing Member which is available for distribution to the Clearing Member's creditors generally.

We are aware that a view has been expressed to the effect that EMIR does not itself modify insolvency or property laws, so that article 48(7) is not sufficient to prevent a balance from becoming part of the assets of the Clearing Member if insolvency law were to provide otherwise. However, the intention of article 48(7) is to avoid that result – the European Commission's intention in proposing EMIR was the reduction of counterparty risk[6], and that policy would be frustrated if the balance became distributable to creditors; and we also consider that such a result would be contrary to section 155A(4)(a) of the Companies Act 1989, which should be construed purposively, in light of the policy objective of article 48(7).

9.7 If a SISO Effective Date occurs in respect of the Clearing Member, SISO may apply as between the Clearing Member and the Client. An amount representing a balance owed by the CCP in respect of the Client's positions and assets at the CCP level may be affected by SISO in the following ways.

9.7.1 If such an amount is paid directly to the Client by the CCP, the amount received may be treated by the insolvency office-holder of the Clearing Member as a partial or complete discharge of obligations owed by the Clearing Member to the Client.

[6] European Commission's explanatory memo COM(2010) 484, para 4.3.4.

9.7.2 If such an amount is paid to the Clearing Member for the account of the Client, that amount would not (as explained in paragraph 9.6) form part of the insolvent estate of the Clearing Member. Therefore, the amount should not be taken into account by the insolvency office-holder of the Clearing Member as a debt eligible for SISO. Notwithstanding the observations made above, if SISO does apply, the Client would not be left in a worse position than in the absence of SISO, because as a practical matter the Client would be able to determine separate mutual amounts equal to amounts which may have been aggregated and set-off under SISO.

Accordingly, in neither case would the Client bear any losses as a result of the effect of SISO.

9.8 The Client Money Rules (where they would apply) expressly exclude a receivable from the CCP in respect of an individually segregated client from pooling of client monies for distribution, as explained in paragraph 7.3.

9.9 If the agreement between the Clearing Member and the Client makes no express provision for over-enrichment due to a receipt of money or other assets by Client direct from the CCP, the Clearing Member may (notwithstanding the purported terms of such agreement) be able to assert a claim for unjust enrichment (or equivalent under applicable law) to avoid the consequence of overpayment to Client, but this would not affect the effect of the direct transfer to, or for the account of, the Client from the CCP as ensuring that the Client's positions and assets are bankruptcy remote.

9.10 In respect of the opening of insolvency proceedings (under the laws of this or another jurisdiction) with regard to other clients:

9.10.1 The laws of this jurisdiction do not permit a challenge to ownership of Client's assets merely based on the opening of insolvency proceedings in any jurisdiction with respect to another client.

9.10.2 The laws of this jurisdiction do not permit a challenge to the contractual entitlement of a Client merely based on the opening of insolvency proceedings in any jurisdiction with respect to another client. With reference to paragraph 4.1.1, we assume in particular, in this regard, that the agreement between the Client and the Clearing Member effectively excludes the rights of third parties under the Contracts (Rights of Third Parties) Act 1999.

9.11 Accordingly, the Client would not be subject to losses under the laws applicable to the insolvency of the Clearing Member in the event of a close-out of the Client's positions and assets at the CCP level.

10. CONCLUSIONS RELATING TO DEFAULT OR INSOLVENCY OF CLEARING MEMBER OR OTHER CLIENTS

10.1 The Client would bear no losses as a result of default or insolvency of the Clearing Member.

10.2 The Client would bear no losses as a result of the default or insolvency of one or more other clients.

CLIFFORD
CHANCE

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Yours faithfully,

Clifford Chance LLP

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