EXPLANATORY MEMORANDUM TO

THE FINANCIAL MARKETS AND INSOLVENCY REGULATIONS 2009

2009 No. 853

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

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 Is to make amendments to Part 7 of the Companies Act 1989 and related secondary legislation.

2.2 Part 7 of the 1989 Act makes provision to safeguard the operation of certain financial markets. Part 7 has been updated on a number of occasions since 1989, but is in need of further updating as a result of changes in practice in the relevant markets and in relation to changes in insolvency law.

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

3.1 These regulations are made using powers—

- exercisable by the Secretary of State and the Treasury jointly to modify the law of insolvency in relation to market contracts under section 158 of the 1989 Act and further and supplemental provision under sections 185 and 186 of that Act (regulations 1, 2(4) – (10), (12) – (16), 3(1)-(5));

- exercisable by the Treasury alone to make provision as to the contracts to be treated as "market contracts" under section 155 of the 1989 Acts (regulation 2(3) and as to the circumstances in which a person is to be regarded as acting in different capacities under section 187(3) (regulation 3(6));

- exercisable by the Treasury with the approval of the Secretary of State to make provision for the default rules of an investment exchange or clearing house under sections 286 and 428(3) of the Financial Services and Markets Act 2000 (regulation 4).

3.2 The provisions made in these regulations either amend Part 7 of the 1989 Act, or are consequent on those amendments. It is considered to be beneficial to users of the legislation amended by these regulations for these provisions to be made in a single instrument.

4. Legislative Context

4.1 Part 7 sets out in relation to recognised investment exchanges and recognised clearing houses what are market contracts and market charges and provides modifications as to how they are to be treated in the event of insolvency of a party to such contracts or charges.

4.2 The scope of Part 7 covers markets contracts connected with recognised investment exchanges (RIEs) or recognised clearing houses (RCHs), certain overseas exchanges and clearing houses, market charges granted in favour of RIEs, RCHs, the Stock Exchange concerning short term certificates and the Bank of England in relation to securities traded in Euroclear UK and Ireland's Crest system, market property and certain supplementary provisions.

4.3 RIEs and RCHs are recognised by the Financial Services Authority under the procedure in Part 18 of the Financial Services and Markets Act 2000 (FSMA). The effect of the recognition is to provide the protections provided for under Part 7 and to take RIEs and RCHs outside of the general prohibition on carrying our regulated activities under FSMA.

4.4 An RIE and an RCH have to meet the criteria for recognition provided for in Part 18 and its secondary legislation.

4.5 Given the dynamic nature of the financial markets Part 7 includes significant powers exercisable in certain cases by the Treasury alone or in others jointly with the Secretary of State for Department for Business Enterprise and Regulatory Reform to amend Part 7.

4.6 The amendments—

- make significant changes to broaden the definition of market contract in section 155;
- explicitly include the concept of "default fund contributions" within Part 7;
- add further references to administration into Part 7 to bring it up to date in relation to the revision of administration brought about by the inclusion of Schedule B1 in the Insolvency Act 1986 by the Enterprise Act 2002;
- require default rules of RIEs and RCHs to refer to and take into account the possibility of cross margining agreements between market participants and markets; and
- enable the extension of default rules of RIEs and RCHs so that a surplus held on a member's house account may be used to make up a deficit on the client account of that member.

5. Territorial Extent and Application

5.1 This instrument applies to the United Kingdom.

6. European Convention on Human Rights

The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Financial Markets and Insolvency Regulations 2009 which amend primary legislation are compatible with the Convention rights.

The remaining provisions of these regulations are subject to the negative resolution procedure and do not amend primary legislation, therefore no compatibility statement is required in relation to them.

7. Policy background

- ***What is being done and why***

7.1 Part 7 of Companies Act 1989 modifies general insolvency law to protect clearing houses and exchanges recognised by the FSA in the event that one of their members defaults. These protections safeguard the integrity of financial markets, and public confidence in them, by minimising the disruption caused by a default.

7.2 Amendments to Part 7 are necessary to reflect developments in market practice and address issues arising from legal changes that have been made since the Part 7 regime was introduced. The proposed amendments will ensure that default funds, which have become an important means for clearing houses and exchanges to offset losses of a clearing member, are given equivalent protection to that already provided for margin contributions; and the surplus from a clearing member trading on his own account may be used to cover any net deficit on that member's client account on a house account.

7.3 The Regulations also provide explicitly for cross-margining agreements between clearing houses, which allow them to pool risk in respect of members they have in common; and widen the definition of "market contracts" to reflect the development of traded instruments, in line with legislation in other jurisdictions.

- ***Consolidation***

7.4 Part 7 has been amended previously but not to a substantial extent. The Treasury does not have plans to consolidate the original text with amendments to Part 7 at this time. Commercial publishers produce consolidated versions of Part 7 with amendments, both in electronic and hard copy versions. A consolidated version of Part 7 is also available on the Ministry of Justice's free website at www.statutelaw.gov.uk.

8. Consultation outcome

8.1 A public consultation on the amendments to Part 7 and the related secondary legislation was launched on 24th July and closed on 16th October 2008. Ten responses were received and a copy of the Summary of Responses is available on the Treasury website (www.hm-treasury.gov.uk).

8.2 The consultation proposals received broad support from respondents, and some technical drafting points were proposed in light of which the Treasury made a number of changes to the regulations, for example including a requirement for RIEs and RCHs to have default rules covering defaults by other RIEs or RCHs. A new provision has also been introduced to make clear that provisions that could apply to insolvency proceedings on foot at the time the regulations come into force will only apply to insolvency proceedings which begin on or after the coming into force of the Regulations. The other provisions by their nature can only apply on a prospective basis.

8.3 Several respondents indicated that they would welcome a broader review of Part 7 in light of market events over the past few months. In due course, the Treasury proposes to undertake a full review jointly with the FSA of the Part 7 regime, taking account of developments in the EU context and in the operation of central counterparties more broadly.

9. Guidance

9.1 The Treasury does not provide guidance on the application and working of Part 7. Guidance is provided in relation to the recognition of recognised investment exchanges and recognised clearing houses in the part of the Financial Services Authority's Handbook of rules entitled "REC".

10. Impact

10.1 The impact on business, charities or voluntary bodies is zero.

10.2 The impact on the public sector is zero.

10.3 An Impact Assessment is attached to this memorandum.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 In light of consultation responses, the Treasury has committed to a broader a review of the Part 7 regime, to be conducted jointly with the FSA. We expect this work will commence later this year.

13. Contact

Hannah Gurga at the Treasury Tel: 020 7270 4345 or email: hannah.gurga@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

IMPACT ASSESSMENT OF THE FINANCIAL MARKETS AND INSOLVENCY REGULATIONS 2009

Impact Assessment of the Financial Markets & Insolvency Regulations 2009

Summary: Intervention and Options

What is the problem under consideration? Why is Government intervention necessary?

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

What are the policy objectives and the intended effects?

To update legislation that safeguards financial markets in relation to central counterparty clearing houses and investment exchanges, enhancing the ability of clearing houses and investment exchanges to ensure that in the event of a market participant's default, markets will continue to operate with integrity and confidence. The Government intends to achieve this though a set of changes to Part 7 of the Companies Act 1989, the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, and the Financial Markets and Insolvency Regulations 1991 relating to: default fund arrangements; the use of house account surpluses to meet deficits on client accounts; cross-margining agreements between clearing houses; the definition of a "market contract"; and certain amendments to the law of administration.

What policy options have been considered?

There are two main options:-

1. Do nothing.

2. Minor legislative amendments to the insolvency regime for central counterparty clearing houses and investment exchanges. The legislative option is preferable as it would reduce systemic risk, support industry developments in operations, risk management and governance, and promote the government's objective to provide the conditions for efficient, stable and fair financial markets.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

Within three years of implementation.

Ministerial Sign-off

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

Signed by the responsible Minister:

IAN PEARSON

Date: 27/3/09

Summary: Analysis and Evidence

COSTS

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

Other **key non-monetised costs** by 'main affected groups'

N/A

BENEFITS

ANNUAL BENEFITS	Description and scale of **key monetised benefits** by 'main affected groups'
One-off **Yrs**	Given the intangible value of increasing confidence in the robust operation of the market and difficulties in estimating the probability of a systemic event, it is not feasible to estimate a figure.
N/A	
Average Annual Benefit (excluding one-off)	
N/A	**Total Benefit** (PV) **N/A**

Other **key non-monetised benefits** by 'main affected groups'

The legislative option would reduce the systemic risk, support industry developments in operations, risk management and governance and promote the government's objective to provide the conditions for efficient, stable and fair financial markets.

Key assumptions/sensitivities, risks

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

Price Base Year 2009	Time Period Years 0	**Net Benefit Range** (NPV) N/A	**NET BENEFIT** (NPV Best estimate) N/A

What is the geographic coverage of the policy? UK

On what date will the policy be implemented?	When the SI comes into force
Which organisation(s) will enforce the policy?	Financial Services Authority
What is the total annual cost of enforcement for these organisations?	£0
Does enforcement comply with the Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	N/A
What is the value of the proposed offsetting measure per year?	N/A
What is the value of changes in greenhouse gas emissions?	N/A
Will the proposal have a significant impact on competition?	No

Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Nil				

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

N/A

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

EVIDENCE BASE

Proposal Objectives

To update legislation that safeguards financial markets, so that in the event of a market participant's default, market integrity continues to be guaranteed.
The rapid evolution of financial markets and their arrangements for addressing risk, including default, means that there is a requirement to update these provisions. The ongoing need for updates was anticipated by the inclusion of significant powers to revise the legislation by statutory instruments.

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

The proposals are in keeping with the 2004 joint recommendations of the Bank for International Settlements (BIS) and the International Organisation of Securities Commissions (IOSCO).

Recommendation 1 of that report, covering 'legal risk' includes the following explanation at paragraph 4.1.3 -

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

Background

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

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

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

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

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

Key Assumptions & Options Summary

Key assumption

● Hourly rates are based on average charge out rates of £402 for legal partners and £170 for legal assistants.

● The cost of assimilation by members is estimated at up to ten hours of work per member, mainly by compliance staff, for 120 members.

● FSA costs based on 30 hours of associate time at a cost of £150 per person hour.

OPTIONS SUMMARY

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

OPTION 1 – DO NOTHING

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

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

Benefits

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

Costs

The 'do nothing' option would conserve the status quo at no direct cost. The potential economic impact from systemic collapse is of course enormous, although the likelihood is remote: the City contributes some 3% of UK GDP and securities trading accounts for some 35% of this. The potential

cost from loss of confidence and reputation is also sizeable, because erosion of status in the global market place would tend to be self-perpetuating.

OPTION 2 – A PACKAGE OF MINOR LEGISLATIVE CHANGES

Benefits

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

The proposed amendments to Part 7 of the 1989 Companies Act, the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, and the Financial Markets and Insolvency Regulations 1991 explicitly provide for -

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

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

Costs

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

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

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

RISK, UNCERTAINTY AND UNINTENDED CONSEQUENCES

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

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

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

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

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

OTHER ISSUES

Small firms impact test

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

Human Rights

As set out in the Explanatory Document, the Government considers that the proposed legislative amendments are compatible with the Convention rights protected under the Human Rights Act 1998.

Competition assessment

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

Equality Assessment

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

Specific Impacts Checklist

The table below confirms which specific impact tests have been considered for this consultation.

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