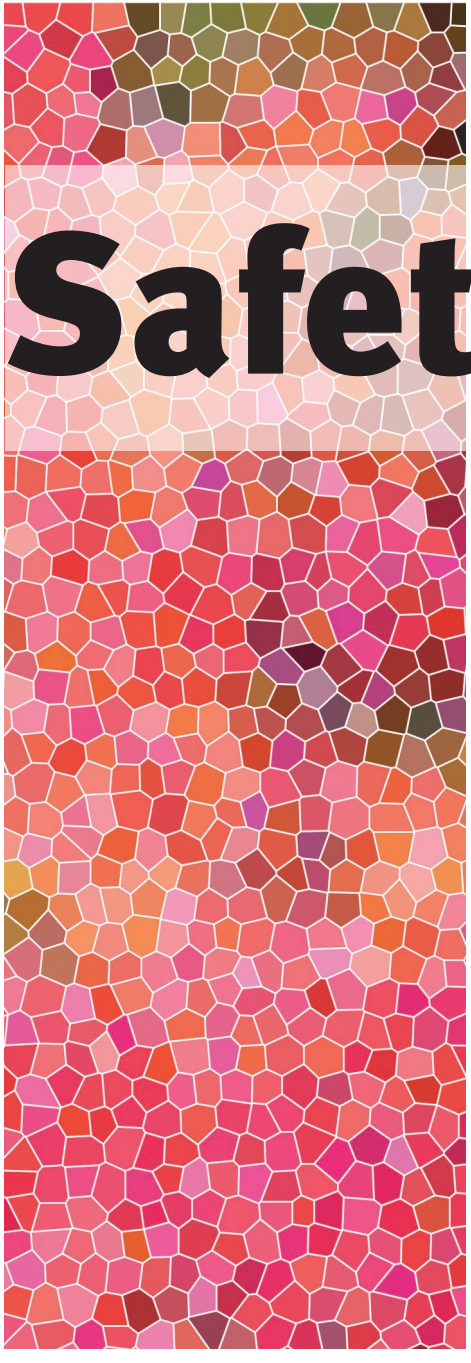


Safety catch

Fund managers are demanding new models to protect client assets from broker bankruptcy, but at what cost?

Anita Hawser

"The Lehman bankruptcy demonstrates that financial institutions may be global in life, but they are national in death—they become a series of local legal entities when they become subject to administration and/or liquidation," Thomas Huertas, director, banking sector, Financial Services Authority, stated at a London financial regulation seminar in 2009. Those comments were made just four months after the demise of Lehman and strike at the heart of efforts by regulators around the world to try and limit the impact of a financial institution's collapse or insolvency on end-investors.

Guaranteed portability?

In the case of Lehman, investors waited years to recover assets, and more recent events such as the failure of MF Global have highlighted the risks of brokers co-mingling client assets with its own and those of other customers. Lehman and MF Global have become pin-ups for a growing movement concerned with protecting investors' assets. James Tomkinson,

Asset protection



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principal consultant at Rule Financial, says regulators in the US and Europe are now developing infrastructures that isolate the possibility of any institution going down.

"Since 2008, the [regulators have] taken a diligent and conscientious approach," he says pointing to the concept of guaranteed portability under EMIR (European market infrastructure regulation), which in the event of a clearing member becoming insolvent, enables investors to transfer their margin and positions to a solvent clearing member.

"Asset protection is the cornerstone of EMIR," says Tomkinson. EMIR requires CCPs and clearing members to disclose publicly the level of protection they offer, including costs, and to offer clients a choice between omnibus and fully segregated accounts or what EMIR calls individual client segregation.

Segregation is enormously important to investment managers, says Jane Lowe, director, markets, at the UK Investment Management Association (IMA). "Although the full range of segregation account options are not yet where investors would like them to be, the EMIR requirements are a huge improvement on what went before," she says. Lowe adds individual client segregation of positions and assets is what most investment managers are looking for.

"Post-Lehman and MF Global, asset segregation is one of the major requirements for the German fund industry," says Rudolf Siebel, managing director for regulatory and industry standards at BVI, Germany's fund and asset management association. "German funds need individually segregated accounts for both initial and variation margin." However, he acknowledges that individual client segregation could be difficult and more costly to implement because of the huge number of individual investment funds in existence.

Should investors opt for individual client segregation or will other forms of segregation suffice? "If you set such a high standard it is going to be more expensive

and for some people it could be inappropriate," Lowe points out. Paul Swann, president, ICE Clear Europe, says the US-owned clearing house advocated choice as the original version of EMIR demanded individual client segregation for everybody. "There are some customers that need absolute certainty where their assets are ring fenced," he explains, "but that is only a subset of customers and there is a cost associated with putting that structure in place."



"The operational complexity of multiple models is a cost."

Paul Swann, president, ICE Clear Europe

Straight-through porting

Xavier Hoche, chief operating officer, trading and securities financing at AXA Investment Managers, says he wants as much clarity as possible from CCPs whether they are able to separately hold the collateral linked to each of its OTC derivatives positions for each portfolio. In addition to segregation, EMIR also introduces a guaranteed porting requirement for client positions and margins in the case of a clearing member defaulting. Nick May, a senior associate within the finance team of law firm Herbert Smith Freehills, says investment managers will want to get assets back in the form they put them up in. Hoche agrees. "Ideally, we would wish those assets to be directly ported from one clearer to the other rather than the CCP retaining those assets and transforming them into cash before porting them."

Eurex Clearing believes it has solved this issue using the double title transfer principle, which enables a registered customer to establish a bilateral relationship with the clearing house in the event of a clearing member defaulting. As it has a direct relationship with the end-client, not the administrator of the defaulting clearing member, the client can fully port their positions

and collateral without them being transformed into cash. "Instead of having to go back into the market and buy their collateral, which is difficult in a distressed market, this allows the buy-side entity to continue clearing and trading," explains Renaud Huck, senior vice president, head of UK institutional investor relations, Eurex Clearing.

Under Eurex Clearing's Individual Clearing Model (ICM) a client's positions and margin are also segregated from that of the clearing member. Huck describes it as the "Rolls Royce model" and says it is supported by legal opinions and bankruptcy regimes in different European jurisdictions. "On paper, legally speaking, it is watertight," he says, "and it does what it says on the tin." But not all firms may want the level of protection provided by a Rolls-Royce. "For the buy-side the question is: do they go for the Rolls Royce, and how much is it going to cost them? Do you want to pay a large amount of money to be as close to risk free as possible?" asks Tomkinson of Rule Financial.



"Co-mingling can present problems for client asset protection from a legal perspective."

Nick May, senior associate, Herbert Smith Freehills

Give LSOC the elbow?

One established form of segregation is the legally separated operationally co-mingled (LSOC) model, which saves on operational costs by holding assets in a clearing member's omnibus account, but for legal purposes the CCP notes that the margin is in a particular customer's name. When the Commodities Futures Trading Commission (CFTC) in the US mandated LSOC as the way forward, May of Herbert Smith Freehills says the buy-side was concerned that there would be contagion if a clearing member failed, and there could be a shortfall in all clients' accounts.

"Co-mingling can present problems for client asset protection from a legal perspective," says May, "and it has not been tested under EMIR." LSOC is the favoured approach in the US under Dodd-Frank, but in Europe it is considered to be inferior to individual client segregation. Similar to LSOC, gross omnibus clearing – where customer margin is segregated from house margin on a gross basis – is being looked at by European CCPs such as Eurex Clearing. "We are also looking at models which offer a certain level of segregation," says Huck. "In the case of a default, an omnibus model can enable the administrator to identify house and client accounts." In an effort to try and establish global standards, ICE Clear Europe is working with the industry to determine whether LSOC is EMIR-compliant for individual account segregation. "The operational complexity of multiple models is a cost," says Swann of ICE



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Clear Europe, "and LSOC is a reasonable iteration in the right direction."

Some are pushing for even higher levels of protection from a clearing broker and clearing house default. Lowe points to the option whereby client collateral is pledged via a custodial account. "Nobody has cracked this yet," she says. "It is complex in terms of the legal documentation required, although on an operational basis it is quite straightforward." Although Eurex Clearing's ICM approach minimises the impact on investors in the event of a clearing broker defaulting, investment managers are still concerned about the second or two of exposure as margin is transferred from the client to the clearing member.

"Anything we post as collateral to the clearer we would like to be passed on to the CCP straight away – provided the CCP accepts such collateral – so we have minimal risk with our clearer," explains Hoche of AXA IM. "The more moves there are, the more chances you have of a failure in between. It would be simpler if we didn't have to move the assets to the CCP but could put them

with a custodian. Instead of having to move cash and securities every day from all of our accounts to the CCP through the clearer, we would only have to flag the collateral at the custodial level to say that these assets should be used."

Ultimate protection

This approach, which is referred to as either the direct delivery or the quad-party model, means the client's margin is delivered directly to the CCP instead of being transferred twice, first to the clearing member and then the CCP. "If we can find a way to directly deliver the collateral from the investment manager to the CCP, that is the ultimate level of asset protection," says Jean-Robert Wilkin, head of client relations and broker-dealers at Clearstream, the international central securities depository owned by Deutsche Börse. "The challenge is to still keep the clearing broker in the equation. They need to be in control to some extent."

Using a third-party custodian to remove residual risk is operationally difficult for the CCPs, says May, as they are used to interacting with the clearing brokers. "In the end clearing brokers will do what the market dictates but they would like to maintain the margin delivered outright to them as they can use part of it for their general business." Given that the quad-party model could take time to implement, Hoche says the LSOC model, which is already live and adopted in the US, would be a reasonable starting point for what investment managers ultimately want to achieve.

Ultimately, Hoche would like to see the market move towards a standard model that is supported by all regulators. "I hope to see some consistency between the various regulators across all countries to ensure that different models are not developed in different countries," he says. "That will help drive costs down. If regulators start interpreting the rules differently then it becomes much more tricky."

May of Herbert Smith Freehills concedes there may be bumps along the road. As EMIR only sets out a basic framework, there will be different legal interpretations. "You still get asset protection through either individual or omnibus under EMIR," he explains, "but the legal means of doing that is different in different jurisdictions, which means there will be inconsistency across CCPs." Swann of ICE Clear Europe also highlights the danger of oversimplifying what is a complex subject. "The system will give a greater degree of assurance around asset protection and the ability to release assets from an insolvent firm more efficiently," he says. "But it is impossible to assure everybody that in every single circumstance, there aren't going to be problems." ■

