



Title Transfer Collateral & Re-hypothecation - Regulators' Growing Concerns

EFMLG in Frankfurt, 30 November 2012

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The general concern of the regulators ...

- Draft recital 37 of the Commission's proposal for a revised Directive on markets in financial instruments (MiFID2) of 20 October 2011:

“The requirements concerning the protection of client assets are a crucial tool for the protection of clients in the provision of services and activities. These requirements can be excluded when full ownership of funds and financial instrument is transferred to an investment firm to cover any present or future, actual or contingent or prospective obligations.”

... how it translated in current initiatives ...

- **New Article 16(10) of MiFID2:**

“An investment firm shall not conclude title transfer collateral arrangements with retail clients for the purpose of securing or covering clients' present or future, actual or contingent or prospective obligations.”

- **Basel/IOSCO consultation paper on margin requirements for non-centrally-cleared derivatives, 6 July 2012:**

“Q24: Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?”



- **Federal Reserve, proposed rule on Margin and Capital Requirements for Covered Swap Entities, 11 May 2012:**

“A covered swap entity that enters into a non-cleared swap or non-cleared security-based swap with a swap entity and posts initial margin to the swap entity with respect to that swap or security-based swap shall require that— (a) All funds or other property the covered swap entity provides as initial margin are held by a third-party custodian that is independent of the covered swap entity and the counterparty; (b) The independent custodian is prohibited by contract from rehypothecating or otherwise transferring any initial margin held by the custodian; (c) The independent custodian is prohibited by contract from reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral under § __.6 for purposes of satisfying the initial margin requirements of this part; and (d) The independent custodian is located in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity.”

- **10th Discussion Paper of the Services of the Directorate-General Internal market and Services on re-hypothecation of 16 October 2012:**

“65. Rehypothecation puts the client at risk: during the time the account provider exercises its rehypothecation right, the client’s ownership right is replaced with a contractual right to return of equivalent securities. This contractual right is not protected by the current MiFID framework (MiFID protects only client’s ownership rights).”

“62/63. In addition to the solutions already discussed at previous meetings, the Working Group could consider the following possible options: Amend the FCD and delete the possibility to grant a 'right of use'. This option would remove legal uncertainties and re-establish the original distinction between 'title transfer' when the client loses ownership and 'security interest' when the client is not at risk of losing its ownership rights.”



- **Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR):**

Article 39(5)(6): A clearing member shall offer its clients, at least, the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection referred to in paragraph 7 associated with each option. The client shall confirm its choice in writing. When a client opts for individual client segregation, any margin in excess of the client's requirement shall also be posted to the CCP and distinguished from the margins of other clients or clearing members and shall not be exposed to losses connected to positions recorded in another account.

- **Proposal for a Regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) of 7 March 2012:**

“Article 35(3), (4) and (5) A CSD shall offer to keep records and accounts enabling a participant to distinguish the securities of each of that participant's clients, if and as required by that participant ('individual client segregation'). A CSD shall publicly disclose the level of protection and the costs associated with the different levels of segregation it provides and shall offer these services under reasonable commercial terms. A CSD shall not use the securities of a participant for any purpose unless it has obtained that participant's express consent.”



- **FSB, Consultative Document Strengthening Oversight and Regulation of Shadow Banking - Shadow Banking Risks in Securities Lending and Repos of 18 November 2012:**

“Recommendation 9: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles: Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;

- *In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and*
- *Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.*

Recommendation 10: An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation.”



... and how it impacts business.

- Collateral is not used a risk mitigation technique it is also regarded as a funding tool.
- One example is the equity prime brokerage business, where the prime broker's right of use ensures low funding costs for hedge funds.
- Other examples are securities lending transactions where the received collateral are used further down the chain.
- The prohibition of title transfer collateral or re-hypothecation changes business and increases costs.
- Some market participants question whether there is sufficient liquid high quality securities to cover the demand.