

Clearing Member Risk Disclosure for Derivative Client Clearing Services Under the European Market Infrastructure Regulation

1. Who should read this document and why?

- 1.1. This document should be reviewed by clients whose derivatives transactions (including both OTC and exchange-traded derivatives) are cleared by Morgan Stanley & Co. International plc ("MSI plc") on an EU-domiciled central counterparty (an "EU CCP") authorised under the European Market Infrastructure Regulation ("EMIR").
- 1.2. This document contains important information for clients making a choice between omnibus and individual segregation for each such EU CCP, and should be reviewed by clients prior to making any election in that regard. Clients should also review information provided by such EU CCPs regarding their segregation offerings, which includes further information on the legal and other implications of particular segregation models and applicable insolvency laws – links to such information have been included below.
- 1.3. An omnibus or individual account at one EU CCP may have certain features which distinguish it (sometimes fundamentally) from omnibus and individual accounts at other EU CCPs. In some cases, an EU CCP may offer more than one variety of omnibus or individual account. This can make selecting the appropriate account a particular challenge for clients. It is important that clients review both this document and the information provided by EU CCPs regarding their segregation models. Should clients have questions on these models, Morgan Stanley can provide assistance and, if helpful, obtain input from the relevant EU CCP – please contact your usual account representative.
- 1.4. This document does not constitute legal or any other form of advice and must not be relied on as such. It provides high level summaries of some key issues, but does not constitute a detailed analysis of all issues which may be relevant in a choice between account types. Clients should conduct their own due diligence and instruct their own professional advisors as appropriate.

2. What are the segregation requirements of EMIR?

- 2.1. EMIR requires clearing members of EU CCPs to offer clients a choice between omnibus and individual segregation of positions and collateral, in relation to cleared derivatives transactions and related accounts maintained at the EU CCPs. EU CCPs must offer clearing members accounts which provide this omnibus and individual segregation. This applies for both OTC and exchange-traded derivatives. Clearing members must make this offer in relation to each EU CCP for which they provide derivatives clearing services to clients.
- 2.2. For clients with exchange-traded derivatives clearing accounts at MSI plc, cash collateral is subject to client money protection where client positions are held in omnibus accounts. This is the case for both EU and non-EU CCPs. If those clients elect an individual segregated accounts at an EU CCP, however, collateral will not be held as client money and will be subject instead to the segregation protections of EMIR. There are differences between the two forms of segregation. These differences and the benefits and risks

relating to this choice are discussed in more detail in paragraph 4.4 below.

2.3. *Omnibus segregated accounts:*

These are accounts where the derivative positions and associated collateral assets of *multiple clients* are recorded in a *single omnibus account* at the EU CCP.

Omnibus accounts will typically have some degree of cross-netting or other mutualisation risk between the clients, whose positions and collateral are recorded in the same account, meaning that if the EU CCP or clearing member defaults there is a risk that losses associated with one client's positions and/or collateral may impact other clients in the omnibus account. The positive value of one client's positions may be netted against the negative value of another client's positions. Collateral is held on a pooled basis, so on a default the net liquidating value of collateral provided by one client may impact other clients in the omnibus account. The specific aspects of this risk will depend on the type of omnibus account offered by the relevant EU CCP and clearing member.

The minimum segregation requirement for an omnibus account under EMIR is that the positions and collateral in the account should be ring-fenced (on both an EU CCP default and a clearing member default) from losses associated with other (house or client) accounts of the clearing member – full mutualisation of risk within the account is permitted. However, beyond mandating the separation of house and client positions and collateral, EMIR does not prescribe a single type of omnibus account, and different EU CCPs may have different offerings which potentially reduce some omnibus account risks that may otherwise exist. Please see below for more detail on this.

2.4. *Individual segregated accounts:*

These are accounts where the positions and collateral of a *single client* are recorded in a *client-specific account* at the EU CCP.

As with omnibus accounts, they are ring-fenced (on both an EU CCP default and a clearing member default) from other (house or client) accounts of the clearing member. As there are no other client positions or collateral in the omnibus account, however, the individual client does not have any mutualisation risk for that individual account relating to other client activity.

For individual accounts, EMIR requires that clearing members post excess collateral received from the client to the EU CCP, to be recorded in the individual account. For this purpose “excess collateral” means, in relation to an individual account, the amount of collateral that the clearing member requires the client to provide to it for positions in the individual account, over and above the amount required by the relevant EU CCP.

3. CCP or Clearing Member default

3.1 A key risk for clients is the default of their clearing member. If a clearing member is declared to be in default by an EU CCP:

- (a) the EU CCP may, at a client's request, try to transfer the client's positions and assets to another clearing member (“porting”); or, if this cannot be achieved,
- (b) the EU CCP will terminate the cleared transactions relating to the client and perform a close-out calculation, taking into account the value of those transactions and the proceeds of liquidating associated collateral.

3.2 A client of a clearing member also faces the risk that an EU CCP defaults. In this case, porting will not be available but transactions will be terminated and a close-out calculation will be performed.

4. Different types of omnibus and individual segregated accounts

4.1. While EMIR sets a minimum standard for omnibus and individual segregated accounts, there are varieties of such accounts which, while all meeting the applicable minimum standard for EMIR purposes, differ in certain respects. We have set out below some key features of omnibus and individual segregated accounts at EU CCPs, which may vary from one EU CCP (or EU CCP model) to another.

4.2. **Net omnibus accounts:**
For certain omnibus accounts, the EU CCP will calculate collateral requirements across all client positions recorded in the account. The positive value of certain client positions may offset the negative value of other client positions, so that the EU CCP calls the clearing member for collateral on a net basis across all positions in the omnibus account. However, the clearing member will call each client for collateral based on *its* exposure to the individual client in isolation.
This will result in the aggregate amount of collateral called by the clearing member from its clients being greater than that called by the EU CCP from the clearing member. EMIR permits that the amount by which the gross aggregate collateral called by the clearing member exceeds the net amount called by the EU CCP may be held by the clearing member and not passed on to the EU CCP.

4.3. **Gross omnibus accounts:**
Certain omnibus accounts will operate on a gross collateral basis, meaning that the EU CCP's collateral requirement will be determined by reference to each individual underlying client's positions in isolation, i.e. there will be no netting of exposures across clients and the EU CCP's collateral requirement will be determined on a gross basis across all clients whose positions are in the omnibus account.

4.4. **Client money protection:**
Exchange-traded ("listed") derivatives – omnibus accounts:
For exchange-traded derivative clients, cash collateral called for positions held in *omnibus* segregated accounts is treated by MSI plc as "client money", subject to the provisions and protections of the UK Financial Conduct Authority's client asset protection rules ("CASS"). In summary, CASS provides that money held by MSI plc as client money will be ring-fenced from its proprietary insolvency estate upon its administration or liquidation, and held on trust for the benefit of relevant clients – meaning that those clients are not exposed to MSI plc insolvency risk in relation to that cash. However, while clients whose money is held by MSI plc as client money will benefit from this protection, the risk of any shortfall in the client money pool is borne by those clients on a pro rata basis. Such shortfalls may occur if a bank, CCP or other party where client money is held defaults and does not repay the full client money balance to MSI plc. The Financial Conduct Authority is currently preparing revisions to CASS, which may impact the nature of this shortfall pooling risk. Cash collateral received from a client which is not transferred on to an omnibus account (e.g. where the account is a net omnibus account, or where the cash has not yet been transferred on to or received back from the relevant CCP) will be held by MSI plc in client money accounts at third party banks. As such, relevant clients will benefit from MSI plc insolvency protection in relation to excess collateral not transferred on to a CCP, or cash "in transit" to or from a CCP.
Exchange-traded derivatives – individual accounts:
For exchange-traded derivative clients with positions held in *individual* segregated accounts, MSI plc will not hold cash in the account as client money. While such cash is still subject to the individual segregated account provisions of EMIR, it will be subject to MSI plc insolvency risk while in transit to or from a CCP.
OTC derivatives:
For clients with OTC derivative clearing accounts (whether positions are held in omnibus or individual segregated accounts), MSI plc takes full title to collateral and cash is not

held by MSI plc as client money.

4.5. Omnibus accounts with enhanced position protection:

The gross omnibus accounts mentioned above may have enhanced segregation features which, while they do not allow that omnibus account to qualify as an individually segregated account for EMIR purposes, mitigate certain risks for clients which might otherwise exist in a minimum EMIR-standard omnibus account. For example, sub-accounts may be established within the omnibus account, which will record the positions of a single individual underlying client. The EU CCP's rulebook may serve to ring-fence these individual sub-accounts from other sub-accounts, so that on an EU CCP or clearing member default, positions in an individual sub-account cannot be netted against positions in other sub-accounts. Some client mutualisation risk may still occur, however, as (notwithstanding client-specific position sub-accounts) the collateral provided by all clients in the omnibus account may be treated by the EU CCP as a single pool, with a proportion of the value of the aggregate pool being allocated to each sub-account. This value allocation process constitutes a degree of mutualisation risk for clients in relation to collateral, i.e. the liquidation value of collateral provided by all clients will impact the value of the pool, and thus the value of an individual client's allocation from that pool.

4.6. Individual segregated accounts with enhanced collateral segregation:

In many cases, full title in collateral will be passed to the relevant EU CCP (i.e. a "title transfer collateral arrangement"). In such cases, neither MSI plc nor the relevant underlying client(s) will retain any legal or beneficial interest in such collateral; rather, MSI plc, as clearing member, will have a claim against the EU CCP for redelivery of equivalent collateral. This claim is subject to the segregation requirements of EMIR, meaning that for omnibus accounts there will be some degree of mutualisation risk, and for individual accounts there should be no mutualisation risk. However, even for individual accounts the claim for redelivery of collateral will be subject to the termination and close-out provisions of the EU CCP's rulebook following a default of the clearing member (if porting is not successful) or EU CCP, so that the claim will be given a value and included in the close-out netting calculation, leaving a net cash amount owed either by the EU CCP or the clearing member in relation to the account. Such arrangements do not preserve any proprietary/ownership rights of the client in relation to a particular collateral asset.

By contrast, some EU CCPs may offer enhanced collateral segregation structures, whereby title in relevant collateral is not passed to the EU CCP and the relevant client's proprietary interest in the collateral is ring-fenced, and thus preserved in the event of a default by the EU CCP or clearing member. Such arrangements may involve holding collateral at third party custodians, subject to multi-party collateral control and security arrangements. Specific details will vary between EU CCPs, and should be considered further where relevant.

5. Key risk comparison

5.1. As outlined above, the key differences in the risks borne by clients when electing a particular omnibus or individual segregated account may depend on the specific features of the accounts offered by the relevant EU CCP. However, below is a summary of some of the key implications.

5.2. Mutualisation risk:

As mentioned above, omnibus accounts will represent a greater mutualisation risk as regards client positions and collateral. Depending on the relevant segregation model offered by the CCP, however, this risk may be reduced so that, for example, one client's positions are not exposed to the performance of another client's positions.

5.3. **Porting:**

EMIR contemplates that positions of a client or clients may be ported from one clearing member to another back-up clearing member following a clearing member default event. If positions cannot be successfully ported, they will be subject to the default-related close-out provisions of the relevant EU CCP's rulebook. The likelihood that porting is successful will depend on a number of factors, for example:

- Availability of a back-up clearing member: For net omnibus accounts, in addition to achieving mutual agreement between clients to a proposed porting arrangement, it may be challenging to find a single back-up clearing member who will accept all positions and collateral associated with the omnibus account, and all necessary client clearing relationships. The difference between the gross amount of collateral called by the defaulting clearing member and the net amount called by the EU CCP (as described in more detail above) will be held by the defaulting clearing member, but any back-up clearing member may require an equivalent amount of collateral from the underlying clients as a condition to accepting porting. For gross omnibus accounts with enhanced segregation, if the relevant EU CCP's rulebook permits, it may be possible for a single underlying client's positions and collateral (more specifically, the value attributed to their collateral, as described in more detail above) to be ported to a back-up clearing member without needing to port other clients' positions and collateral.
- Compliance with transfer requirements under EU CCP rules: A client may only port positions in compliance with the transfer period and other requirements specified in the EU CCP's rulebook. Once such transfer period has expired, the EU CCP will be able to liquidate positions and collateral and will no longer be required to facilitate porting. In order to facilitate porting it may be possible for the client (with an individually segregated account) to act as an interim clearing member, pending an ultimate successful porting to a back-up clearing member. This will be subject to the conditions of the relevant EU CCP rulebook (for example, a requirement to contribute to the EU CCP's default fund).

5.4. **Return of amounts directly to client:**

For individual segregated accounts where porting is not successful and the relevant client is known to the EU CCP, the EU CCP may be able to return excess amounts due from the EU CCP in relation to an individual account directly to the relevant client.

5.5. **Transit risk:**

As discussed in paragraph 4.4 above, MSI plc will treat cash collateral as client money *only* for exchange-traded derivatives held in *omnibus* segregated accounts. Only those clients will benefit from client money protection to mitigate collateral transit risk.

6. Operational risks

6.1. A number of EU CCP segregated account structures are new, from both an operational and legal perspective. In that regard, operational risks are hard to quantify. Clients should ensure that relevant operational processes and requirements are carefully assessed prior to implementing a segregation election, and that appropriate testing is undertaken.