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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 140 – UNSETTLED OTC TRADES

Legal Proposal for normative changes to address the risk of market instability in the event of the insolvency of an investment firm, with particular reference to the problem of unsettled OTC cash equity trades

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1. Introduction and Executive Summary

A) Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

1.2 Following the insolvency of Lehman Brothers International (Europe) Limited ("LBIE"), a large number of settlement instructions relating to Over-the-Counter ("OTC") cash equity trades to which LBIE was party remained unsettled and suspended within the CREST system operated by Euroclear UK & Ireland ("EUI"). These instructions had been matched and entered the CREST system for settlement before LBIE's accounts were suspended and no funds were made available by LBIE's settlement bank for settlement to be completed.

1.3 Under the CREST Rules, neither party to a matched settlement instruction has the ability unilaterally to amend or delete that settlement instruction in respect of a trade (whether within or outside the context of insolvency). In the absence of default provisions in the majority of OTC cash equity trade agreements, the administrators of LBIE and its counterparties were unable to reach agreement as to how to deal with the outstanding settlement instructions. One of the possible reasons for this is that they had conflicting duties and interests in pursuing a resolution of the issue. As a result, these instructions remained in the CREST settlement system for three weeks and two days after the appointment of LBIE's administrators, at which point EUI (after consultation with the Financial Services Authority ("FSA") and other regulatory authorities) determined to exercise its powers under its existing default arrangements by directing that each party instruct their mutual deletion.

1.4 During the weeks in question, non-defaulting counterparties experienced increasing market and operational uncertainty arising from their perceived vulnerability to settlement and the consequent risk of exposure to trades which they had, by then, already replicated in the market for contractual and regulatory reasons. The high volume of trades involved and the very large exposure of the non-defaulting parties caused considerable market uncertainty and could have had significant adverse consequences for the financial system. It was in response to this increasing systemic risk that EUI determined (after consultation as above) to exercise its default powers against LBIE and its CREST member settlement counterparties.

1.5 This kind of turmoil in the financial markets was not specific to OTC cash equity trades. The London Stock Exchange in particular experienced very considerable disruption owing to uncertainty as to whether a trade had been effected under its Exchange Rules. This was due in part to poor record-keeping by many firms and because, in many cases, there was no explicit

agreement between parties regarding the venue of execution. Other exchanges faced similar problems.

1.6 The FMLC considered this to be an important area in which inchoate legal uncertainty had crystallised and so formed a Working Group to investigate the causes of the market disruption; what could be done to ensure that, where a trade fails to settle because one of the parties to the trade has become insolvent, each party is certain as to its contractual obligations; and whether additional steps might be appropriate to provide further clarity to market participants as to the circumstances in which matched, but unsettled, settlement instructions will be removed from the CREST system.

B) Executive Summary

1.7 OTC cash equity trading in London is, in a significant number of cases, executed without any formal terms of business, either over the telephone or via a brief electronic message. When a trade has been agreed, each side (or its settlement agent) enters settlement instructions (or "transfer orders") into the CREST settlement system and those instructions are "matched". If one of the parties becomes insolvent after the instruction has entered into the CREST system, but before settlement, it is highly unlikely in practice that the instruction will settle on the settlement date. There are many reasons why settlement might fail but, in most cases, it is because the insolvent party does not have sufficient funds or requisite securities to comply with its delivery or payment obligation or its CREST membership is suspended by EUI.

1.8 In this event, there is often legal uncertainty (in the absence of express contractual terms governing the trade itself) as to whether the innocent party is able to terminate the OTC trade contract when the counterparty fails to comply with its delivery/payment obligation on the date specified for settlement. Since the OTC trade contract is in practice unlikely to contain any default provisions, the question turns on whether it can be shown, on a contractual analysis, that there is a specific time clause and that this clause is an essential term of the contract.

1.9 The timing of settlement for OTC cash equity trades is not usually stipulated when the trade is agreed over the phone or electronically, but it seems likely that market practice in the UK is sufficiently certain to cause a term to be implied in the trade contract that settlement will take place three days after execution. However, there is uncertainty as to whether this would constitute an essential term of the contract in that a court's determination of this question would depend upon the specific factual circumstances in which the particular trade was made and, as a result, may vary from one trade to another. Hence a court may consider trading parties to have attached greater importance to the timely settlement of a trade if the securities in question were highly volatile owing to decreased trading volumes, for example, with the consequence of reduced liquidity in the market.

1.10 Where the settlement date is an essential term of a particular trade contract, failure to comply with that term would constitute a repudiatory breach. Even where the innocent party is not entitled to terminate a trade which fails to

settle on the intended settlement date, he may give notice to his counterparty at any time after that date requiring the contract to be performed within a reasonable period of time and may be entitled to terminate the contract if his counterparty fails to satisfy this requirement. Where it is clear that the defaulting party does not intend to perform the contract, no notice need be given.

1.11 However, regardless of whether the solvent counterparty is entitled to terminate its trade contract with an insolvent counterparty, it – or its settlement agent – is prevented by the *Settlement Finality Directive* (98/26/EC) from unilaterally deleting settlement instructions from the CREST settlement system as from the point at which they are "matched" in the system – which, in accordance with and as permitted by the Directive, is the moment specified by the CREST Rules at which such instructions become "irrevocable". The fact that a settlement instruction has become "irrevocable" for the purposes of the Directive does not mean that it is guaranteed to settle. It simply means that the instruction is incapable of being revoked unilaterally by the instructing party (or its insolvency office-holder) and, to that extent, remains a subsisting permissive authority to its addressee to execute it.

1.12 Indeed, while it is correct that there remains the risk that an irrevocable transfer order attributable to an insolvent party (or its settlement agent) may proceed to settlement, there are a number of reasons in practice (discussed further below in paragraphs 2.32 *et seq.*) why settlement is unlikely to occur in the absence of consent or co-operation on the part of interested parties. In particular, in determining how to respond to a participant's default, EUI (in its capacity as a recognised clearing house) exercises quasi-public law functions. The proper performance of these functions requires EUI to balance and be satisfied of a number of conditions before it could allow settlement to proceed.

1.13 However, the regulatory discretion delegated by statute to EUI in determining how it would respond under its default powers to matched, but unsettled, irrevocable transfer orders in its system caused increasing concern to market counterparties to LBIE; in particular, to those participants who had replicated their positions under OTC trades by entering into replacement contracts with other parties and who would, therefore, incur material settlement, market and other risks if EUI subsequently determined to permit the outstanding settlement instructions of the insolvent party to proceed to settlement. A number of key market participants have indicated that they need and require greater *ex ante* certainty as to the action that EUI will take in relation to outstanding settlement instructions where the relevant trade has failed to settle because of the counterparty's insolvency. The FMLC has, therefore, in conjunction with EUI, LIBA and other market participants considered the following options with a view to ensuring the required degree of market confidence in the UK's procedures to mitigate the risks in relation to unsettled OTC trades arising out of the insolvency of a major financial institution:

a) Pre-agreed provisions between market participants, which would remove the legal uncertainty as to parties' contractual obligations when one of the parties to an OTC cash equity trade becomes insolvent. The London Investment Banking Association ("LIBA") has produced a first draft of a protocol to

which market participants can adhere that would provide a mechanism to be triggered in an insolvency scenario which would close out and value positions against an insolvent party where no other provisions exist for this purpose.

b) Amendment to the Insolvency Rules to require an insolvency practitioner of an insolvent party to instruct EUI to delete any outstanding, unsettled settlement instructions relating to OTC cash equity trades which have been terminated pursuant to the default provisions in the LIBA protocol (or equivalent market agreement). These settlement instructions would then be match-deleted by the non-defaulting party.

c) The detailed guidance to CREST Rule 13 published by EUI on 3 March 2009, which clarifies the steps that EUI can be expected to take in the event that it is notified that insolvency proceedings have commenced against a CREST member.

d) The interposition of a central clearing party between the buy and sell sides of each OTC cash equity trade, which would guarantee the settlement of the trade by becoming the counterparty to each of the original parties.

e) A move to an alternative model of responding to settlement instructions which are attributable to an insolvent company so that such instructions are immediately suspended or deleted. Under this proposal, EUI would be required to disable immediately the membership of an insolvent CREST member upon becoming aware of its insolvency and permanently "neutralise" all the unsettled matched settlement instructions relating to trades with the insolvent participant by, for example, moving them to a "shadow account". If an administrator[1] of the insolvent member wishes to settle any transactions after its insolvency, it would have to re-issue the relevant settlement instructions into the CREST system. The transaction would settle only if these instructions were matched by new instructions from the relevant settlement counterparty.

1.14 In the FMLC's view, proposal (e) in the paragraph above would provide the most effective and least costly way to ensure the required level of confidence in the UK market's procedures for dealing with market, settlement and other risks created by the insolvency of a major financial institution. It is acknowledged, however, that there are a number of possible drawbacks to the proposed solution; and these are described below.

a) The solution would increase the likelihood (as compared with the current regime) that an insolvent party will be unable to satisfy its delivery/payment obligation under OTC cash equity trades on the intended settlement date, since an administrator is likely to have insufficient time to re-input all relevant settlement instructions into the CREST system before the intended settlement date has ended (assuming that the administrator has been able to re-activate and fund the CREST account of the insolvent company). If it is decided that time is of the essence in a particular trade contract, the proposal would therefore increase the risk of the insolvent party committing a repudiatory

[1] References made to "administrators" in this paper shall be taken to include any other insolvency office-holders (except where specific reference is made to LBIE's administrators).

breach of its delivery or payment obligation. As a result, the proposed solution may reduce or eliminate any room for manoeuvre on the part of the administrator and with it the practical advantage to be gained by meeting obligations incurred by the insolvent entity. In turn this may adversely affect the administrator's ability to achieve the statutory purpose of the insolvency procedure.

b) It would not be possible for EUI to distinguish within the short timeframe envisaged by the proposed solution those settlement instructions which relate to OTC cash equity trades from other settlement instructions (e.g. those relating to on-exchange market contracts) entered by the insolvent party into the CREST settlement system. The solution would therefore result in all unsettled matched settlement instructions relating to trades of an insolvent CREST member being "neutralised", including any exchange trades to which it is party, as soon as EUI becomes aware of the insolvency event.

c) Where settlement is effected by an "indirect participant" in the CREST system, through a settlement agent that is a CREST member, the insolvency of the indirect participant cannot be dealt with by the proposed solution because the instructions will have been given by the settlement agent and will contemplate that settlement takes place from the agent's own CREST member account. In other words, there may be no way of discerning which settlement instructions relate to trades entered into by that indirect participant, and which settlement instructions related to trades entered into by the CREST member or its other (solvent) clients. This means that the solution is likely to have a limited beneficial impact on market certainty during an administration or other insolvency process where the insolvent firm is an indirect participant, rather than a CREST member.

d) Where a large financial institution becomes insolvent it is likely that the insolvent entity will have been participating in the settlement system not only on its own behalf but also on behalf of any brokerage clients and other smaller entities for whom it may be acting as settlement agent. The "neutralising" of the insolvent entity's settlement instructions will inevitably affect trades to which these clients are party. There must, therefore, be a concern that adopting the proposed solution will increase market disruption for those clients and increase the likelihood of those clients breaching their market contracts.

e) Where the insolvent entity has been dealing with another CREST participant, it is possible that there are clients for whom that other participant is acting in relation to the unsettled trades. These clients may also experience difficulties in effecting alternative delivery and settlement arrangements once the pre-existing settlement instructions have been "neutralised".

f) There may be practical restrictions on the ability of administrators to re-input settlement instructions where the IT systems of the insolvent firm are down. Market and regulatory actions may offer the principal means of ensuring that arrangements are organised so that an administrator would be able to continue to operate such systems, but this would be difficult to enforce where the service provider is based in another jurisdiction or the relevant contract is not

governed by English law. Legislation cannot by itself, therefore, solve this problem.

1.15 However, the FMLC considers that these concerns are almost certainly outweighed by the benefit of the proposed solution to market participants of increased market certainty. In particular, it would enable counterparties in any future default scenario to manage more effectively their market, settlement and other risks and to facilitate compliance with their regulatory obligations without their being required to rely on the exercise by EUI, albeit in consultation with the FSA and other regulatory authorities, of its regulatory discretion in a manner favourable to the interests of the market as a whole.

1.16 The solution should ideally be coupled with market adoption of the LIBA protocol (or equivalent market agreement), which would entitle a solvent party to close out and value OTC positions against an insolvent party and therefore remove any uncertainty as to whether the solvent counterparty is entitled to terminate the trade contract. This in turn would address any concerns that the solution might in certain circumstances deprive the insolvent estate of the ability to meet its trading obligations, since the solvent party would be entitled to terminate the parties' contractual obligations under the terms of the protocol. If the solvent party chooses to do so, the trade which has been terminated no longer represents any possible benefit to the insolvent estate; if it chooses not to do so, the insolvent party will have the opportunity to meet its trading obligations after it has re-enabled and funded its CREST account.

1.17 The FMLC understands that EUI would, subject to further consultation and market support, amend CREST Rule 13 in order to implement the solution. It further understands that EUI would recommend that the implementation of the solution should be effected only in conjunction with an appropriate amendment to the *Uncertificated Securities Regulations 2001*, which would allow the operator of the settlement system to interfere with dematerialised instructions in the manner proposed by the FMLC. HM Treasury has the power to amend these Regulations under the *Companies Act 2006*. However, if it feels that this power does not extend to its amending the Regulations in this way, it may alternatively use the powers conferred upon it by section 2(2) *European Communities Act 1972* to re-implement the Regulations so that they make explicit that the proposed method of interference with dematerialised instructions by the operator of a settlement system is permitted.

2. The current regime and its consequences

2.1 This section explores in detail how legal uncertainty, market, settlement and other risks may arise when a party to an OTC cash equity trade becomes insolvent. OTC trades comprise any trades which are not made on, or under the rules of, an exchange.

A) Trade formation and settlement

2.2 The large majority of OTC trades in London for cash equities are executed over the telephone or via brief electronic message (e.g. by using a commercially available messaging service such as Bloomberg) and, typically,

the only terms agreed are the price, quantity and the identity of the securities. The settlement date will generally be assumed and the location or manner of settlement will not usually be stipulated. Despite their lack of detail, these agreements give rise to legally enforceable obligations for the parties involved. Further information on market practice for the formation of OTC trades, together with an analysis of the legal enforceability of such agreements, is contained in Appendix One.

2.3 When the terms of an OTC cash equity trade have been agreed, the parties may enter settlement instructions in respect of that trade into the CREST or other settlement system on or before the intended settlement date. Alternatively, a party to the trade may arrange for the trade to be settled through a settlement agent or a brokerage firm (which may, in turn, use a settlement agent).[2] In this case, the instructions will be given by the broker or settlement agent and settlement will take place from that party's CREST member account. EUI may have no relationship with the trading party itself and will frequently have no knowledge of the identity of this party.[3] A diagram of the trade and settlement life cycle of a typical OTC cash equity trade involving a settlement agent is contained in Appendix Two.

2.4 There are various models for brokerage and settlement in this context. A broker or settlement agent may agree to act as "principal" or surety vis-à-vis market counterparties, which means that it will assume legal responsibility to the counterparty to perform (or ensure the performance of) the delivery or payment obligations under the relevant trade (e.g. in the event that the client is itself unable to discharge these obligations); or, conversely, it may not accept any legal responsibility as principal or surety on the trade and merely act as the conduit through which its client will perform its own contractual obligations to deliver securities or make payment to the contract counterparty. The nature and extent of the legal responsibilities assumed by the broker or settlement agent will, of course, depend upon the terms of the contract in question and the nature of the services that it has agreed to provide to its client.

2.5 A settlement agent is to be distinguished from a "CREST settlement bank", whose function is to provide credit or liquidity to the party (CREST member) for whom it is acting. CREST settlement banks provide credit facilities to their CREST member customers, the credit risk under which can generally be controlled through the unfettered ability of such banks to "disable the member's cap" in CREST – so as, in effect, to disable that member's ability to make any further payments through the CREST system unless and until the settlement bank "re-enables" the cap. Typically, the settlement bank takes a charge over securities in its client's CREST member account as security for the exposures that the settlement bank will incur in making payments through the CREST system on behalf of the member.

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[2] Parties which are self-clearing and self-settling, such as LBIE, do not have to appoint a settlement agent or broker.

[3] A possible exception is in the case of trade feeds submitted to EUI by certain stock exchanges, including the London Stock Exchange, which include a "Trading Member ID". However, this may serve to identify the central counterparty, brokerage firm or other third party rather than the underlying client itself.

2.6 If one of the trading parties were to become insolvent after settlement instructions are entered into the CREST system, but before settlement, it is in practice highly unlikely that the trade will settle on the intended settlement date, unless a settlement agent or broker is acting on its behalf as principal or as surety (in the manner described above). There are many reasons why settlement might fail but, in most cases, it is because the insolvent counterparty's settlement bank (or settlement agent) will be unwilling to extend, or procure the extension of, any further credit to enable payments to be made for the insolvent counterparty's account; and/or because insufficient securities are available to the insolvent counterparty to meet its delivery obligation; and/or the relevant settlement bank may take action to enforce its security over the insolvent company's available CREST securities; and/or the relevant CREST membership may have been suspended by EUI pursuant to its default powers in order to protect the integrity of the CREST system and its other participants.

B) Contractual position

2.7 Owing to the way in which OTC cash equity trades are executed, there is some legal uncertainty as to whether the innocent party is able to terminate its trade contract with a counterparty who fails to comply with its delivery or payment obligation on the intended settlement date. Trade contracts do not typically contain any formal terms of business, which might include appropriate default provisions. Nor are any default provisions incorporated by reference into these agreements, in contrast to exchange trades and those OTC trades involving central counterparties (known as "CCPs"), which will normally be subject to the default rules of the relevant trading venue or (as between the CCP and its clearing members) the clearing house.[4] The question turns on whether it can be shown, on a contractual analysis of the trade in question, both that there is a specific time clause and that this clause is an essential term of the contract.

2.8 The timing of settlement is not usually stipulated when a trade is executed over the phone or electronically. However, the FMLC understands that it is customary for settlement of OTC cash equity trades in the UK to take place three business days after the execution of the trade and that this allows traders to assume a specific date for settlement where this is not expressly agreed. It appears likely therefore that a court would deem there to be a specific time clause in a typical OTC cash equity trade. However, if a court were to conclude that trade practice is insufficiently certain to imply a fixed settlement date where this has not been expressly agreed by the parties, the court would most likely deem a typical OTC cash equity trade to be subject to an implied term that the parties complete the transaction within a reasonable time.[5] In this case, the insolvent party is unlikely to be in breach of the trade contract by failing to deliver or pay the requisite securities or cash on the date specified as the settlement date through the securities settlement system.

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4 See footnote [14] below.

5 See *Bear Stearns v Forum Global Equity Ltd* [2007] EWHC 1576 (Comm)

2.9 On the assumption that a court would find a typical OTC cash equity trade to contain a specific time clause, the counterparty's failure to comply with its delivery or payment obligation on the intended settlement date would entitle the innocent party to terminate its trade contract only if this clause is an essential term of the contract (i.e. that "time is of the essence" in respect of this obligation). The question is considered in a number of authorities. In *re Schwabacher*[6] there are dicta to the effect that with regard to contracts for the sale of shares as well as of a business as a going concern time is of the essence at law and in equity. Parker J said this (at p. 129):

> "With regard to contracts for the sale of shares, I think that time is of the essence both at law and in equity. Shares vary continuously in price from day to day and that is precisely why courts of equity have considered such a contract to be one in which time is of the essence of the contract, and not like a contract for the sale and purchase of real estate, in which time is not of the essence of the contract. It is in effect analogous to another class of cases in which equity views time as always being of the essence of the contract – namely where there is a purchase of a business and its goodwill as a going concern….."

2.10 In *Hare v Nicoll*[7] (a case involving an option relating to a block of shares in a private company, which were of a highly speculative nature and liable to considerable fluctuation in value) each of the members of the Court of Appeal (Willmer, Danckwerts and Winn LJ) indicated a view (having stressed that the shares were of a volatile character) that time would be of the essence. Winn LJ, in particular, expressed himself quite broadly (at p 147 F-G):

> "In my judgment, where there is a provision for the purchase of shares upon payment by a stated date, it is to be presumed, in the absence of any contrary indication, that the parties to such a contract have impliedly stipulated and mutually intend that the time of payment shall be of the essence of the contract….."

2.11 In *Grant v Cigm*,[8] however, in the course of delivering an interlocutory judgment Judge Weeks QC (sitting as a Judge of the High Court) indicated a view (at p.31) that the dicta in *re Schwabacher* and of Winn LJ in *Hare v Nicoll* may be too wide and that:

> "A property company may be different to a trading company and a company in one line of business may be different from a company trading in another less dynamic market."

2.12 In light of this judgment and previous case authority, Davis J recently concluded in *Msas Global Logistics v Power Packaging Inc*[9] that the question of whether the parties intended to make time of the essence of a contract should depend upon the "factual context in which the contract is made" and "the subject matter of the contract". The judicial authorities referred to above

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6 (1908) 98 LT 127
7 [1966] 2 QB 130
8 [1996] 2 BCLC 25
9 [2003] EWHC 1393 (Ch), at 43

concern the purchase of shares in private unquoted companies; to date, the courts have not been asked to consider this question in the context of a liquid trading scenario, where the securities in question are listed on an exchange or otherwise freely tradeable on an MTF or other market. There is as yet, therefore, no definitive judicial authority on this question.

2.13 The basis for the courts deciding that time was of the essence in several of the above cases was, in part at least, that the innocent party was exposed to the fluctuation in the value of the shares while settlement was outstanding; and this reasoning may be equally applicable to shares traded in the public markets. LBIE's counterparties in particular were exposed to sharply falling share prices while their trades remained outstanding beyond the date stipulated for settlement. However, dealing in cash equity securities acquired by a trader is not usually dependent on settlement having taken place, which casts doubt on the importance attached to the settlement date by the contracting parties at the time that the trade is agreed. In other words, when a trader has entered into an OTC cash equity trade for the acquisition of securities, it is quite possible that he will enter into a further agreement to dispose of, or otherwise deal with, those securities before he has taken physical delivery of them.

2.14 It is also noted that courts are generally reluctant to find that time has been made implicitly of the essence in a contract because the consequences of doing so can be severe. In this case, for example, a trading counterparty would be entitled to treat the trade as being at an end after only a very short delay in delivery/payment. Every party whose trade is "out of the money" would be expected to exercise its right to terminate that trade if its counterparty has failed to comply with its delivery/payment obligation on the intended settlement date, whilst each of those whose trades are "in the money" would refrain from doing so.

2.15 The impact of this would be particularly serious given that it is far from unusual for trades to settle not on the intended settlement date, but shortly afterwards, owing to a lack of stock (for example, if incoming deliveries have not yet settled or where "technical netting" is required to resolve a hold up) or a lack of cash or liquidity (where, for example, a party is awaiting receipt of payment due from the settlement of a large value transaction) or because one or both counterparties have failed to input correct details of the settlement into the settlement system. Normal market expectation in these circumstances is that the trade will go on to settle in due course when the correct settlement instructions have been entered or the requisite cash or securities are available. In the latter case, settlement is facilitated in part by the operation of the CREST system, which re-processes the settlement instructions at regular intervals on and after the intended settlement date until the delivery and payment obligations are met on both sides. Indeed, it may be in part for this reason that the rules of certain UK exchanges, including the London Stock Exchange, provide that time shall not be of the essence in respect of the parties' delivery obligations;[10] and this itself may be seen by the courts as expressive of a wider market custom or usage to be implied into OTC trade contracts for the sale and purchase of liquid securities.

[10] See for example Rule 5130 of the Rules of the London Stock Exchange.

2.16 However, the "factual context" and "subject matter" of each OTC cash equity trade may be different. A court may consider trading parties to have attached greater importance to the timely settlement of a trade if the securities in question were highly volatile owing to decreased trading volumes, for example, with the consequence of reduced liquidity in the market. Thus one might conceivably be expected to present a stronger argument that the parties intended to make time of the essence where the trade in question was agreed during a period of severe economic stress. However, the only conclusion that can be drawn with confidence is that a court's determination of this question would depend upon the specific factual circumstances in which the particular trade was made and, as a result, may vary from one trade to another.

2.17 Where the intended settlement date is an essential term of a particular trade contract, failure to comply with that term would constitute a repudiatory breach. Even where the innocent party is not entitled to terminate a trade which fails to settle on the intended settlement date, he may give notice to his counterparty at any time after that date requiring the contract to be performed within a reasonable period of time.[11] What is reasonable will depend upon all the facts and circumstances of the case.[12] Where it is clear that the defaulting party does not intend to perform the contract, no notice need be given.[13] The effect of the notice is to displace the interference of equity in the common law rights of the parties. This does not mean that the defaulting party commits a repudiatory breach of contract if it fails to perform within the reasonable period stipulated in the notice. He will have committed a repudiatory breach only if his continued failure goes to the root of the contract and deprives the innocent party of a substantial part of the benefit of the contract.

2.18 In the event that a repudiatory breach is committed, the solvent party would have the right to accept the insolvent party's repudiation and to treat the contract, including his own obligation to pay or deliver cash or securities, as at an end. Acceptance of repudiation in this way would put to an end the market risk which the solvent party would face if the trade remained open, crystallises his loss (if any) resulting from the insolvent party's failure to settle and enables him to put on any replacement trade or otherwise hedge himself in the market, safe in the knowledge that he cannot be compelled to complete the original trade.

C) Settlement instructions

2.19 Regardless of whether the innocent party is entitled to terminate its trade contract with an insolvent counterparty, it (or its settlement agent) is prevented from unilaterally deleting the settlement instructions in respect of that trade from the moment at which they are "matched" in CREST, which is the moment specified by the CREST Rules at which such instructions (or "transfer orders") become "irrevocable".

2.20 This aspect of irrevocability is obligatory within "designated" settlement systems under the *Settlement Finality Directive* (98/26/EC) (the "SFD"). The

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11 *Parkin v Thorold* (1852) 16 Beav. 59; *Green v Sevin* (1879) 13 Ch D 589

12 *Stickney v Keeble* [1915] A.C. 386

13 *Re Stone v Saville's Contact* [1963] 1 WLR.

SFD was implemented in England and Wales by *The Financial Markets and Insolvency (Settlement Finality) Regulations 1999* (the "SF Regulations").[14] These SF Regulations provide for the designation of payment systems by the Bank of England and securities settlement or clearing systems by the FSA, so that the systems thus designated may receive the "finality" benefits and protections afforded by the SFD.

2.21 The SF Regulations set out several criteria which need to be met for a system to be designated. As a practical matter, a system must have not less than three participants, of which one must have its head office in Great Britain.[15] The governing law of the system (i.e. the law which governs its rules for the execution of transfer orders through the system) must be English, Scots or Northern Irish, and the system must give effect to transfer orders.

2.22 The SFD requires that transfer orders shall be irrevocable, shall be legally enforceable and, even in an insolvency of a participant, shall be binding on third parties if entered into a system before the opening of the insolvency proceedings. Exceptionally, the transfer orders shall also be binding where entered into a system after the opening of insolvency proceedings if they are carried out on the same day and the operator of the system was not aware (and should not have been aware) that those proceedings had been opened at the time settlement occurs.[16] Insolvency proceedings must not have retroactive effect (so the zero-hour rule that exists in certain jurisdictions has to be disapplied by the implementing legislation) and the parties' rights and obligations are to be determined in accordance with the governing law of the

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[14] The SF Regulations were implemented under the authority of section 2(2) of the *European Communities Act 1972* and came into force in 11 December 1999. The regulations originally covered England, Scotland and Wales; they were extended to Northern Ireland in 2006. This section of the FMLC Paper focuses on the laws of England and Wales. Part VII of the *Companies Act 1989* ("Part VII") has for some years provided benefits similar to those contained in the SFD in relation to recognised investment exchanges ("RIEs") and recognised clearing houses ("RCHs"). Under the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, an investment exchange and a clearing house (which itself enters into market contracts) is required to have "default rules" in order to receive recognition under Part XVIII of the 2000 Act. Such default rules must enable action to be taken in respect of unsettled market contracts where a member of the exchange or clearing house is or appears to be unable, or likely to become unable, to meet its obligations in respect of a market contract. (Similar requirements apply to systems designated under the SF Regulations, which must have "default arrangements" to limit systemic and other types of risk which arise where a participant appears to be unable or likely to become unable to meet its obligations in respect of a transfer order.) Neither those market contracts nor action taken pursuant to the relevant market's settlement or default rules can be regarded as invalidated by any English insolvency law (section 159 *Companies Act 1989*). An advantageous status was also given to charges given in favour of an RIE or an RCH. Similar protections are afforded to the "default arrangements" of a designated system, and "collateral security charges" taken for the purpose of securing rights and obligations potentially arising in connection with the system, by virtue of the SF Regulations. Where a system is both recognised for the purposes of Part VII and a designated system for the purposes of the SF Regulations (for example, the CREST system), there is therefore a degree of overlap between the benefits arising from Part VII and those arising from the SF Regulations. Part VII is also relevant because legislation prepared in connection with it (for example, *The Financial Markets and Insolvency (Money Markets) Regulations 1995* and *The Financial Markets and Insolvency Regulations 1996*) formed the basis for the drafting of the SF Regulations, which retained concepts like "default rules" (default arrangements) even though they were not an express feature of the SFD.

[15] The SFD classifies participants in designated systems according to certain categories of person, including credit institutions, investment firms, settlement agents and central counterparties. The focus of the SFD is on corporate undertakings, but it does not expressly exclude natural persons; nor does it exclude the possibility of a system having members who are not "participants" as defined in the SFD (although the insolvency advantages of the SFD would not extend to such members). The SF Regulations, however, expressly disapply various rules of English law which only apply to natural persons and therefore clearly contemplate a designated system having private individuals as participants, as the CREST system has. Indeed, upon designating the CREST system as a "system" for the purposes of the SF Regulations, the FSA exercised its powers under regulation 8 by electing to treat "CREST personal members" (individuals) and corporate bodies (who were not within the class of credit institutions etc. that are expressly recognised as "institutions" (participants) under the SFD, as "institutions" (participants) for the purposes of the SF Regulations.

[16] Article 3(1)

system, even in insolvency. There must also be no unwinding of netting within a system.[17] These principles are essentially reflected in the SF Regulations, which first disapply insolvency law in general terms by reference to transfer orders, the system's default arrangements and any collateral security provided in connection with the system, and which then proceed to disapply specific provisions of UK insolvency law.[18]

2.23 The SFD and the SF Regulations require that (in addition to obligations on the participants for the sharing of information with the financial authorities, insolvency officials and others) the rules of the system must specify the point at which a transfer order takes effect as having entered the system and also the point after which a transfer order may not be revoked by a participant or any other party. These rules are designed to protect the stability and efficient operation of the system; and to minimize the disruption to a system caused by the insolvency of a participant or a purported revocation of a transfer order in a way which is inconsistent with the operational procedures of the system. A transfer order may, however, be terminated or otherwise fail to settle after that point by reason of action or inaction on the part of the system itself, if permitted or required by the rules and operational procedures of the system.[19] This reflects the fact that a transfer order is a *permissive* authority or mandate addressed to (amongst others) the operator of the system to execute a delivery of securities or payment. It cannot itself impose any obligation upon the addressee to effect such a delivery or payment – which remains essentially a matter of separate contract between the parties to the trade and/or their settlement agents.

2.24 Since, in the interests of the integrity and stability of the system, a participant (whether solvent or insolvent) is prevented from unilaterally deleting or amending outstanding transfer orders that have become "irrevocable" in accordance with the system's rules, a solvent party who (with a view to controlling its market risk on an OTC trade) has entered into a replacement contract will not itself be able to control the settlement and other risks arising out of the potential settlement of the relevant outstanding transfer order. In light of the events that unfolded after the collapse of LBIE, it seems clear that these risks are unlikely to be resolved quickly (if at all) by the parties agreeing to the mutual deletion of the relevant instructions. This is because, in the event of the failure of a major market participant, there are likely to be conflicting duties imposed on, and interests held by, the insolvency office-holder and the solvent counterparty; and because the administrator is unlikely to prioritise this issue (as discussed below). The solvent party is therefore, in principle, left with the settlement and other risks derived from matched settlement instructions in the CREST system since it remains a possibility that,

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17 Article 3(2)

18 See Reg 14(1) and (3), Regs 16 and 17

19 The SFD does not otherwise stipulate what the rules of a system should say. It is therefore for the system and its relevant designating authority to ensure that the rules are consistent with the general purpose of the SFD: to achieve finality of transfer orders, even in an insolvency of one of the participants. The SF Regulations require a system to have "default arrangements which are appropriate for that system in all the circumstances" (paragraph 6 of the Schedule), but do not prescribe what those arrangements must be. The SFD and the SF Regulations also contained an early statement of the PRIMA principle (the Place of the Relevant InterMediary Approach), to the effect that the determination of the parties' rights in respect of securities and rights in securities which are recorded on a register, account or system located in a Member State shall be governed by the law of that Member State (see Art 9(2) and Reg 23).

at some future point in time, these OTC trades could settle, thereby effectively recreating trades and associated exposure that the solvent party may, as a matter of law, have validly terminated. Such a possibility could also result in complex restitutionary claims with all the related expense.

2.25 Where settlement occurs despite the valid termination of the trade contract in question, the solvent party would very likely have a good claim against the insolvent company for the return of its cash or securities but this will be a personal claim against an insolvent company rather than a proprietary one and is therefore likely to be worthless in practice. The insolvent company's moratorium would also prevent its counterparty, at least initially, from seeking any redress through the courts.

2.26 This risk is further increased by the prospect that an administrator may, in exercising his statutory duty to maximise the value of the insolvent estate, try to select favourable trades (known as "cherry picking") where he is legally able to do so, forcing the settlement of the profitable ones while disowning unprofitable ones.

D) The perspective of the insolvency practitioner

2.27 The functions of an administrator are to achieve the statutory (or other) purposes for which he has been appointed, i.e. chiefly to rescue the company as a going concern or to maximise the returns for the company's creditors or to wind-up the company. Unfortunately, either/both of these statutory purposes will exert normative pressure toward both action and inaction at one and the same time. An administrative delay is crucial to the administrator's ability adequately to take stock of the insolvent entity's commercial and trading positions but the same delay can jeopardise the administrator's ability to meet outstanding obligations on those same positions and thus either preserve the business as a going concern or effect an orderly wind-up.

2.28 Insolvency practitioners who take appointment are partners in major accountancy firms. Typically, they will have no particular expertise in the workings of securities settlement systems or other clearing houses and their firms will have finite resources. Neither their firms, their legal advisers nor in many cases the operations executives of the businesses which are the subject of the relevant insolvency proceeding, are likely to have a great deal of experience of the workings of clearing houses and securities settlement systems. This may sound surprising but when market participants are going concerns, clearing and settlement systems can be operated on the basis that those concerned know what happens in practice. If there is a major insolvency, those concerned need to understand their strict legal rights and obligations and this requires a far greater understanding of the systems than they have.

2.29 When administrators take office in a major case, they are inundated with what are called "day one" issues i.e. immediate priorities such as dealing with employees, directors, suppliers, customers, press etc. If these issues are not dealt with immediately, the business (and/or the company's ability to realise its assets) may fall apart. Furthermore, although administrators sometimes have advance notice of their intended appointment (and therefore some time to plan

for it), there is, in many cases, little opportunity for any pre-planning. Both Barings Bank and LBIE, for example, were appointments with virtually no notice.

2.30 It follows that administrators may require a significant period of time in order to be able to decide whether or not to adopt trades which are unsettled within a major securities settlement system. For example, there were 15,000 outstanding trades left unsettled when Kaupthing Singer & Friedlander ("KSF") went into administration and the figure for LBIE will have been much higher.

2.31 Other points to note are that the settlement instructions within the CREST system may be part of wider structured trades (such as the contracts for differences hedged with underlying securities developed by KSF). Administrators will want to consider the trades as a whole. If an administrator is faced with structured products then it is unlikely that he will have understood the mechanics of the product in the first five days of the administration or other insolvency process, let alone what to do with thousands of trades where similar products are involved.

E) The regulatory and operational context

2.32 Before turning to some possible solutions, it is appropriate to put these concerns in their regulatory and operational context. While it is correct that there remains the risk that an irrevocable transfer order attributable to an insolvent party (or its settlement agent) may proceed to settlement, there are a number of reasons in practice why settlement is unlikely to occur in the absence of consent or co-operation on the part of interested parties. First, the insolvent party's (or its settlement agent's) settlement bank must be willing to continue to provide credit or liquidity to enable the trade to settle. In the event of a failure of a major market participant, a settlement bank's immediate and natural concern is likely to be to manage and limit its exposure to its failed client and settlement of outstanding trades is unlikely to achieve that purpose. Secondly, EUI, which will have suspended the defaulting member's participation, must be willing to re-enable or reactivate its membership. In taking such a decision EUI would be exercising functions delegated to it by legislation and would exercise them in close consultation with the main affected parties, the FSA and other relevant regulatory authorities (including the Bank of England).[20] Thirdly, the FSA, which is responsible for designating EUI as a system under the SF Regulations, would have to be satisfied that those arrangements were "appropriate for the system in all circumstances".[21]

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[20] EUI must be satisfied that such action was in the wider interests of the market as a whole having due regard to a number of relevant factors (which it has enumerated in paragraph 2 to its Guidance for CREST Rule 13 set out at Appendix Three

[21] The degree of market confidence that has traditionally been placed in "recognised bodies" (such as EUI), to whom regulatory functions have been delegated by statute or statutory instrument, finds expression in section 291 of the *Financial Services and Markets Act 2000*. This provides that a "recognised body and its officers and staff are not to be liable in damages for anything done or omitted to be done in the discharge of the recognised body's regulatory functions, unless it is shown that the act or omission was in bad faith"; there is a derogation from this statutory immunity in section 291(2) in relation to unlawful acts or omissions under section 6(1) of the Human Rights Act 1998.

2.33 The experience of the aftermath of LBIE's collapse is, in the FMLC's view, that these inherent regulatory and operational protections for market participants are not in themselves enough, at least in the case of the failure of a major financial institution, to ensure market confidence in the likely response that the UK's securities infrastructure will make when faced by such a failure. A number of key market participants have indicated that they need and require greater *ex ante* certainty as to the action that EUI will take in relation to outstanding settlement instructions where the relevant trade has failed to settle because of the counterparty's insolvency.

3. Possible Solutions

3.1 The FMLC has concluded that such *ex ante* certainty is indeed a desirable outcome and, notwithstanding the existing regulatory and operational constraints on EUI in responding to the failure of a major market participant, market confidence in the UK's securities infrastructure requires something more to support financial stability were another major financial institution to become insolvent. Reforming this area is not, however, a simple task and one of the reasons for this is that there are duties incumbent upon market participants and administrators. In trying to arrive at a possible solution, the FMLC conducted a limited review of the position in other jurisdictions, in particular within Europe.[22]

3.2 Most settlement systems in Europe appear to operate in the same way as the CREST system in stipulating that unmatched instructions can be deleted unilaterally at any point, whereas instructions which have been matched can only be deleted bilaterally. However, approaches vary. The different approaches appear to fall into the three categories set out below, the first of which is by far the most common.

a) Even where bilateral cancellation is required for matched trades, a number of settlement systems have rules which provide that matched settlement instructions which are not cancelled by the parties, but which do not perform, will expire in the system automatically after a certain period of time following the intended settlement date. The number of days differs by jurisdiction, but from the jurisdictions within the material reviewed for these purposes, it appears to vary between 6 and 30 days, but is generally either 10 or 20 days. While this does offer certainty and finality in due course, there is still a period of time during which there remains uncertainty and risk for market participants. In addition, it does not resolve the contractual issue (i.e. the rights and obligations under the OTC trade itself), which remains to be resolved between the parties.

b) A small number of the jurisdictions for which information is readily available appear to permit unilateral cancellation of trades even if matched (for example Belgium and Norway, but in the case of Norway on the buy side only). Again, the contractual position remains an issue for the parties to resolve between themselves.

[22] The jurisdictions considered for these purposes were Austria, Belgium, Czech Republic, Denmark, Finland, France, Italy, The Netherlands, Norway, Portugal, Sweden, Hungary and Spain.

c) An alternative method (but one which had not been adopted by any of the European jurisdictions on which this study is based) is to interpose a central clearing party between buyer and seller for OTC trades. (It should be noted that the interposition of such a central counterparty already occurs for trades executed on most UK regulated markets and MTFs.) The central clearer then takes on the delivery risk from the seller and the credit risk from the buyer. This is the method used by the Depository Trust & Clearing Corporation ("DTCC") in the United States to settle trades through its subsidiary, the National Securities Clearing Corporation ("NSCC"), as a result of which all trades through NSCC involving Lehman Brothers were cleared and settled. While this would appear to be an effective means of providing a degree of *ex ante* certainty currently lacking in the UK for OTC trades, its implementation would involve significantly more than a rule change since it would entail moving to a clearing and settlement system rather than the existing settlement system and/or other clearing house.

3.3 This comparative analysis of settlement systems by jurisdiction was supplemented by other ideas from the Working Group and led the FMLC to consider the following possible solutions to provide the degree of *ex ante* certainty that certain key participants have indicated they need to ensure continuing confidence in the UK market's securities infrastructure for OTC trades.

A) Pre-agreed provisions between market participants

3.4 The legal uncertainty surrounding OTC cash equity trades that resulted from LBIE's administration has focused the industry's attention on the advantages of pre-agreed provisions. LIBA has announced an initiative, supported by a number of its members, which will endeavour to put in place a protocol to which market participants can elect to adhere and which would provide a mechanism that can be triggered in an insolvency to close out and value positions against an insolvent party where no other provisions exist for this purpose. This would settle the question as to whether the solvent party is entitled to terminate an OTC cash equity trade where its counterparty becomes insolvent. A first draft of this protocol has been produced by LIBA and is contained in Appendix Four.

3.5 This proposal could be adapted to form a multi-party solution by introducing multi-way agreements. It would theoretically be possible, as a result, to make provision for the insolvency, not only of settlement agents, sponsors and members-acting-as-principal which assume liability as a contracting party to or in respect of the trade, but also of all non-members of the settlement system, whether principals, brokers or clients who assume such contractual liability.

3.6 A market protocol may also be used to address certain other areas of uncertainty in the execution, clearing and settlement process. These might include, for example, the uncertainty faced by certain counterparties to trades with LBIE as to whether their trades were deemed to be on or off exchange. If this were made clear in a market protocol, parties would know at the outset whether their trades are subject to the default rules of the relevant trading

venue in an insolvency. In addition, the extent of the market or settlement risk faced by parties to a trade may be reduced if a market protocol were to provide for a shortened settlement period, although it is acknowledged that this would likely raise significant operational challenges.[23]

3.7 An immediate difficulty in the adoption of a market protocol, however, is that it is likely to be difficult to introduce within the protocol the full range of agency arrangements necessary to provide for termination of a trade in view of the complicated relationships that are relevant to the activity of settlement (see above and below).

3.8 Furthermore, if the protocol is not adopted universally across the market, it seems very much as if it will suffer similar problems of uncertainty as to whether or not it applies to trades, as those problems faced by exchanges in enforcing their rules in the post-MiFID environment. As mentioned above, certain counterparties to trades with LBIE faced uncertainty as to whether their trades were deemed to be on or off exchange. This uncertainty arose because, in many cases, no explicit agreement had been reached regarding the venue of execution and record keeping was poor. Likewise, even where both parties have not adhered to the protocol, it may nevertheless be argued that its terms are implied in the trade contract by market usage, amongst other things. The FMLC would suggest therefore that regulatory measures are taken to incentivise parties to adopt the protocol in order to ensure that it is applied across the entire market.

B) Amendment to Insolvency Rules

3.9 The insolvency rules may be amended to require an insolvency practitioner of an insolvent party, whether or not it is a member of the CREST settlement system, to delete or to procure the deletion of any outstanding, unsettled settlement instructions relating to OTC trades which have been terminated pursuant to the default provisions in the LIBA protocol or equivalent market agreement. These settlement instructions would then be match-deleted by the non-defaulting counterparty.

3.10 Under this proposal, an insolvency practitioner would have no discretion as to whether to arrange for the deletion of the insolvent party's "orphan" settlement instructions and his doing so would be compatible with his duty to the general creditors, since a trade which has been terminated no longer represents any possible benefit to the estate.

3.11 However, unless the LIBA Protocol (or equivalent market agreement) were used universally across the market, it is likely to be operationally difficult for the insolvency practitioner to distinguish trades which are subject to a termination clause from other trades. Even where a counterparty serves a default notice which includes a schedule identifying those trades that it has elected to terminate, the administrator would nevertheless have to verify that those trades are subject to the protocol. This may require a significant amount

[23] It would be necessary to carry out considerable further analysis as to the extent of these operational challenges before reaching a conclusion on the viability of shortening the settlement period. The views of exchanges, central clearing parties and market participants (including central securities depositories) would be required for this purpose.

of time; and there may also be uncertainty as to whether the protocol applies to the trade contract for the reason given in paragraph 3.8 above. It is therefore important that, if this proposal is to be adopted, regulatory measures are taken to ensure universal take-up of the protocol when the insolvency rules are amended.

C) Guidance to EUI rules

3.12 On 3 March 2009, EUI published detailed guidance to CREST Rule 13 (which sets out, amongst other things, the powers reserved to EUI under its default arrangements to minimise systemic and other risks which arise in the event of the insolvency of a CREST participant). This guidance describes the considerations and processes which EUI adopts (and would continue to adopt) in determining how to discharge its regulatory functions when exercising its default powers. As such, it clarifies and provides a public statement of the steps that it can be expected to take in the event that it is notified that insolvency proceedings have commenced against a CREST member. EUI based its guidance to its existing default powers on its own experience of the LBIE default and on actions which it had successfully taken in managing previous default situations.

3.13 The detailed guidance is set out in full in Appendix Three. In summary, it states that participation in CREST will be suspended immediately upon EUI receiving notification of a participant's insolvency, but may be re-enabled by EUI within 5 business days of disablement if certain conditions are fulfilled. The insolvent participant will otherwise be permanently suspended from the CREST system. Furthermore, EUI will direct the insolvent participant (and all counterparties to the relevant trades) to enter matched deletion instructions if the insolvent participant is still in settlement default on the tenth business day after its re-enablement or its settlement instructions still remain in the CREST system following its permanent disablement.

3.14 Although this guidance is a notable contribution to the efforts made by all market and market-facing institutions to afford greater predictability in this area, the FMLC considers that the guidance is, without more, unlikely to provide sufficient legal certainty to ensure continuing market confidence in the face of the insolvency of another major market participant. The challenge to be addressed is the need to minimise to the extent logically possible the perceived market, settlement and other risks which partly crystallised upon the collapse of LBIE. The FMLC does not consider that this guidance has done that; and does not consider that the regulatory and operational context in which CREST Rule 13 and the related guidance must operate (as outlined above) is sufficient either.

D) Central Clearing

3.15 A central clearing party could be interposed between the buy and sell sides of each OTC trade, which would guarantee the settlement of the trade by becoming the counterparty to each of the original parties. The central counterparty would, in effect, take on the delivery risk from the seller and the credit risk from the buyer. This is the method used by the DTCC in the United

States to settle trades through its subsidiary, the NSCC, and, as a result, every trade involving Lehman Brothers which was processed through NSCC was cleared and settled (see paragraph 3.2(C) above).

3.16 The use of central clearing, however, has significant cost implications for trading activity in the markets, and so this is unlikely to be an attractive solution for UK market participants in relation to OTC trades. In addition, central clearing does not necessarily protect the client of an insolvent principal, since the central counterparty does not intervene between the two, but rather between the two principals (as clearing members of the CCP).

3.17 It is also unclear whether it would be possible for this solution to be implemented by FSA regulation or by cumbersome legislative changes, and whether the existing clearing infrastructure would be fit to accommodate the increased volume of trades.

E) Adopt alternative approach to dealing with instructions of insolvent parties

3.18 An alternative proposal, which has been discussed and developed in consultation with EUI, would be for EUI to adopt a new approach in its Rules in relation to matched, but unsettled, instructions attributable to an insolvent participant. This would be one under which, contrary to the current approach to a recognised body's exercise of its regulatory functions, EUI would retain no discretion in determining what action to take in response to the insolvency of one of its participants. EUI would be required automatically and immediately to disable the relevant CREST membership and delete or otherwise "neutralise" outstanding settlement instructions attributable to the defaulting member and, correlatively, those of the settlement counterparty.[24]

3.19 Under this proposal, EUI would immediately disable the CREST membership of an insolvent party upon becoming aware of its insolvency and permanently "neutralise" all the unsettled matched transfer orders relating to trades with the insolvent participant by, for example, moving them to a "shadow" member account. Once transferred to the shadow account the transfer orders would be prevented from settling. If an administrator of the insolvent member wishes to settle any transactions after its insolvency, it would have to re-issue the relevant settlement instructions into the CREST system (and provide evidence of its capacity to act on behalf of the insolvent party). The transaction would settle only if these instructions were matched by new instructions from the relevant counterparty.

3.20 This solution builds on the procedures that are already adopted by EUI in response to a participant's insolvency. Crucially, however, it removes any room for discretionary action on the part of EUI and "accelerates" the matched deletion of outstanding settlement instructions in a way that is not currently achieved under EUI's existing procedures.

[24] A similar approach is adopted by the securities settlement system operated by Clearstream Banking SA, which provides that settlement instructions attributable to an insolvent participant are effectively cancelled when Clearstream becomes aware of the insolvency event.

4. Recommended Solution

4.1 In the FMLC's view, the alternative approach to dealing with instructions of insolvent parties (Proposal E) would provide the most effective way to address the issues of market, settlement and other risks which currently arise following the insolvency of a party to an OTC trade. The proposed solution has the immediate advantage that it would allow market participants to obtain a high-degree of outcome certainty without incurring the costs of central clearing. It is also consistent with the approach taken by at least one other key settlement system. Ideally, the solution would be coupled with market adoption of the LIBA protocol (or equivalent market agreement), which would close out and value positions against the insolvent party.

4.2 However, it is acknowledged that there are a number of possible drawbacks to the proposed solution; and these are described below.

(i) Effect on fulfilment of delivery obligations under OTC cash equity trade contracts

4.3 The proposal would increase the likelihood (as compared with the current regime) that an insolvent party will be unable to satisfy its delivery or payment obligation on the intended settlement date by requiring that transfer orders be re-input into the settlement system, since an administrator is very likely to have insufficient time to arrange for this to be done before the intended settlement date has ended (assuming that it has been able to re-activate and fund the CREST account of the insolvent company). If such failure entitles the solvent counterparty to terminate its trades with the insolvent company, then this proposal would reduce the insolvency office-holder's ability to achieve the purpose of the insolvency procedure by meeting its trading obligations and by incurring new ones where necessary.

4.4 The question as to whether a party has a right to terminate its trades with a counterparty who has failed to perform its delivery or payment obligation on the settlement date is discussed in section 2(B) above. In short, it would be necessary for the solvent party to show for this purpose that, on a contractual analysis of the OTC trade in question, there is a specific time clause and this clause is an essential term of the contract.

4.5 It seems possible – even likely – that a court would deem there to be a specific time clause in a typical OTC cash equity trade owing to established market practice that settlement should take place three business days after execution of the trade. However, in the event that a court concludes that there is a lack of market consensus on this point, the court would likely deem an OTC cash equity trade to be subject to an implied term that the parties complete the transaction within a reasonable period.[25] If so, the insolvency office-holder would be afforded some time to re-input settlement instructions into the CREST system, or achieve settlement via some other means, so that the trade can settle within the relevant contractual timeframe; although, it is acknowledged that the re-inputting of instructions may itself be delayed by

[25] See *Bear Stearns v Forum Global Equity Ltd* [2007] EWHC 1576 (Comm)

difficulties with the insolvent company's IT systems, amongst other things (see paragraphs 4.22 and 4.23 below).

4.6 On the assumption that a court would find a typical OTC cash equity trade to contain a specific time clause, there is uncertainty as to whether a court would hold this clause to be an essential term in a liquid market in that the court's determination of this question would depend upon the specific factual circumstances in which the particular OTC trade is made (see section 2(B) above). If it is decided that time is of the essence in a particular trade contract, the proposal would increase the risk of the insolvent party committing a repudiatory breach of its delivery or payment obligation. As a result, the proposed solution may reduce or eliminate any room for manoeuvre on the part of the administrator and with it the practical advantage to be gained by meeting obligations incurred by the insolvent entity. In turn this may adversely affect the administrator's ability to achieve the statutory purpose of the insolvency procedure.

4.7 It is also acknowledged that the administrators of Teathers Limited (formerly Landsbanki Securities (UK) Limited) were able to reactivate the CREST account of the insolvent company soon after it had entered administration in October 2008 and, as a result, Teathers Limited was able to settle all of its outstanding trades (and consequently was not, at least within this initial period, placed in default by exchanges). However, the FMLC would argue that an orderly operation or wind-down of a company is very much more difficult to achieve in the case of a large market participant; and this has been exemplified by the effects of LBIE's insolvency.

4.8 It is worth noting in this context that market adoption of the LIBA protocol would remove any uncertainty as to whether time is of the essence in an OTC cash equity trade. The protocol would entitle the solvent party to terminate its OTC cash equity trades immediately after the counterparty has become insolvent. This in turn would address any concerns that the solution might in certain circumstances deprive the insolvent estate of the ability to meet its trading obligations since the solvent party would be entitled to terminate the parties' contractual obligations under the terms of the protocol. If the solvent party chooses to do so, the trade which has been terminated no longer represents any possible benefit to the insolvent estate; if it chooses not to do so, the insolvent party will have the opportunity to meet its trading obligations after it has re-enabled and funded its CREST account.

(ii) Effect on settlement of exchange trades

4.9 It would not be possible for EUI to distinguish within the short timeframe envisaged by the proposed solution those transfer orders which relate to OTC cash equity trades from other transfer orders entered by the insolvent CREST member into the settlement system. This proposal would therefore seek to "neutralise" all unsettled matched transfer orders relating to trades of the insolvent CREST member, including any exchange trades to which it is party, as soon as EUI becomes aware of the insolvency event.

4.10 Exchange trades will normally be subject to the default rules of the relevant exchange (and, where a CCP is involved, the default rules of that clearing house), which may close out all such trades in the event of the default of one of the parties.[26] However, a company's insolvency does not constitute a specific event of default under the rules of every stock exchange. The Rules of the London Stock Exchange, for example, do not prescribe any specific events of default but state that the Exchange may declare a member firm to be a "defaulter" if it is unable or appears likely to become unable to fulfil its obligations in respect of one or more Exchange trades.[27] Indeed, the FMLC understands that it is not uncommon for the London Stock Exchange to decide against declaring a default following the insolvency of a party; or to declare a default some time after the insolvency event, when there is some degree of certainty that the insolvent party will be unable to satisfy its delivery or payment obligations.

4.11 The proposal would not appear, at first, to affect the discretion of an exchange in deciding whether or not to declare that a member firm is in default. Where a large, sophisticated or systemically important institution becomes insolvent, it is likely that an exchange would declare a default soon after the relevant insolvency event occurs because of the wider systemic consequences for the relevant market if prompt default action were not taken by the exchange. In the case of LBIE, for example, the London Stock Exchange made a declaration of default as soon as it became insolvent. With regard to other, smaller institutions, it may be possible for an administrator to re-input settlement instructions relating to the unsettled exchange trades if the insolvent company is in a position to comply with its delivery or payment obligations, and the exchange will retain its ability to refrain from declaring the member firm in default in these circumstances. This result is supported by the terms of exchange settlement rules, which typically provide that time is not of the essence in respect of the parties' delivery obligations, such that the solvent counterparty would be prevented from terminating the exchange trade immediately following breach of that provision.[28]

4.12 However, removal of all pending settlement instructions from the CREST system in relation to the insolvent party is likely in certain circumstances to result in significant settlement delays given the potential difficulties for the insolvency office-holder in re-inputting instructions (IT difficulties, reconciliation, network provider and settlement bank issues, for example) and having those instructions matched by all counterparties. In such cases, the exchange is almost certainly more likely to conclude, as a result of the proposed solution, that a particular insolvent member is unable to meet its exchange obligations.

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[26] Where the exchange in question does not have default rules, the effect of the proposal on the fulfilment of the insolvent party's delivery obligations in respect of trades made on that exchange will be as described in paragraphs [4.6] to [4.7] above.

[27] See Rule D100 of the Rules of the London Stock Exchange.

[28] See, for example, Rule 5130 of the Rules of the London Stock Exchange.

(iii) Settlement of trades through a settlement agent

4.13 There are a few agency contexts which may require special consideration when the merits of the proposed solution are discussed.

a) The insolvent party is acting through a settlement agent

4.14 Where delivery or payment is to be effected by an "indirect participant" in the CREST system acting through a settlement agent (that is a CREST member), the insolvency of the indirect participant cannot be dealt with by the alternative approach, i.e. by disabling the relevant transfer orders or instructions, for the simple reason that the instructions will have been given by the (solvent) settlement agent and will contemplate that settlement takes place from the agent's own account. In other words, there may be no way of discerning which transfer orders relate to trades entered into by the (insolvent) "indirect participant". This means that the alternative approach cannot be implemented to create market certainty during an administration or other insolvency procedure where the insolvent firm is an indirect participant rather than a CREST member.

4.15 In these circumstances, i.e. the insolvency of an indirect participant, the settlement agent may have accepted the risk of the indirect participant's default or insolvency by assuming contractual responsibility for effecting settlement and discharging the transfer order irrespective of the indirect participant's ability to meet its obligations under the trade, or it may not. These two possibilities are addressed in the paragraphs below.

4.16 If the settlement agent has assumed that responsibility by acting as "principal", or surety, vis-à-vis market counterparties and CREST then it will, presumably, discharge the transfer instruction by effecting settlement even though it thereby incurs an expense which it may not be able to recoup from the estate of the insolvent participant. In these circumstances, however, there is no period of uncertainty for the counterparty to the trade or settlement instruction and no threat to market stability other than indirectly through the realisation of this credit risk by the settlement agent and the consequent threat to its own institutional stability. There does not seem to be a risk to market stability in these circumstances which needs to be addressed by a development of the current settlement rules, rather the issues arising in relation to the exposure of settlement agents to insolvent clients can be managed by supervision of the agents themselves.

4.17 If, on the other hand, the settlement agent has not assumed ultimate responsibility for the discharge of the transfer instructions that it has given on behalf of clients then, once aware of the participant's insolvency, the settlement agent is unlikely to be willing to make cash or securities available for settlement and this is likely to result in a period in which unsettled settlement instructions remain in the settlement system. In this case and given the operational impossibility described in the paragraph above of isolating quickly and efficiently the settlement instructions attributable to the trades of the insolvent entity, the transfer instructions entered by the settlement agent are likely (in the absence of remedial action required by EUI) to remain in the

system being continually re-presented for settlement after non-delivery on the general cycle which applies to other (i.e. solvent) situations in which trades fail to settle on their due date. The counterparty, however, is likely to experience considerably greater uncertainty with respect to the unsettled trade than it would in any of the normal trading situations in which trades initially fail because non-delivery in these circumstances leaves the counterparty with nothing except a claim on the estate of an insolvent entity. Thus the market disruption may be considerable depending on the size of the insolvent entity.[29]

4.18 One solution to this problem would be for EUI to exercise its existing powers under its CREST membership agreements by requiring the affected CREST members to identify and input matched deletion instructions in relation to those unsettled settlement instructions that relate to the trade of the insolvent indirect participant.[30]

b) The insolvent party is acting as a settlement agent for other market participants

4.19 Where a large financial institution, which provides prime brokerage or other custody-related services, becomes insolvent it is likely that the insolvent entity will have been participating in the settlement system not only on its own behalf, but also on behalf of any brokerage clients and other smaller entities for whom it may be acting as settlement agent. The "neutralising" of the insolvent entity's transfer orders will inevitably affect trades to which these clients are party. There must, therefore, be a concern that adopting the proposed alternative approach will increase the likelihood of those clients breaching their market contracts by virtue of the fact that the approach makes it less likely that the insolvent entity's administrator will be able to effect the statutory purpose for which he was appointed and meet its settlement obligations by means of the pre-insolvency matched transfer orders (after re-enabling and funding the relevant CREST account). Any conclusion that the trades entered into by those clients are due to be performed on the express or implied settlement date and that time is of the essence in those contracts, will exacerbate this concern by reducing the time available for the underlying clients to put into effect alternative delivery and settlement arrangements.

4.20 However, on closer inspection, the FMLC considers that this concern is almost certainly outweighed by the benefit of the alternative approach to the clients of the insolvent entity of increased market certainty. Clients of the insolvent entity can only hope to recover their assets from the administrator and, if necessary, meet their market obligations through other channels once it is

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[29] In practice, the FMLC has been given to understand that EUI manages this sort of default situation by exercising its powers under its CREST membership agreements with the relevant settlement agent (see clauses 14.2 and 15.2 of the CREST Member Terms and Conditions).

[30] Another solution which has been discussed would be for EUI to effect a change to the CREST Rules whereby instructions relating to persistently unsettled trades, i.e. those which had been re-presented for settlement a specified number of times or over a specified period without success, are declared "failed" and thereafter "neutralised" even without the insolvency of a CREST member. (Presumably that would also be done by transferring "failed" instructions to a shadow account). However, there appear to be significant objections to this reform, which have to do with existing market conditions and practices and the preponderance of settlements which do not settle on the due date but shortly thereafter as mentioned above. It is beyond the scope of this section of the paper to address these objections in detail. However, it seems unlikely that any specified period of this kind could be short enough, given the above, to offer any more certainty than can be achieved under the current CREST Rules and guidance. Moreover, on balance the FMLC believes that the systemic risk flowing from the insolvency of an indirect participant in the settlement system, which almost by definition is likely to be a significantly smaller market participant, is not sufficiently large to overcome the objections mentioned above.

absolutely clear that the office-holder will not be required to, or will be prevented from, using the assets to meet existing matched transfer orders. Once prompt settlement of existing settlement instructions in full looks to be in doubt, protracted uncertainty about whether transfer orders will be executed using clients' assets or not is damaging to the market as a whole.

c) The insolvent entity is party to a trade with a market counterparty which is acting as a settlement agent for other market participants

4.21 Where the insolvent entity has been dealing with another CREST participant, it is equally possible that there are clients for whom that other participant is acting in relation to the unsettled trades. Here too, any concern about the difficulty of effecting alternative delivery and settlement arrangements once the pre-existing transfer orders have been "neutralised" is outweighed by the benefit of market certainty for these indirect participants. In the wake of the LBIE insolvency, the vulnerability experienced by settlement agents about their exposure to "orphan" transfer orders vis-à-vis the LBIE administrator and their need to insure against this exposure manifested in many cases as an unwillingness to release clients' assets, which were in their temporary custody pending delivery to LBIE, back to clients. Owing to this temporary restriction, some clients found themselves unable to deal with their assets efficiently in a volatile market. One of the merits of the alternative approach is that it would, by ending the phenomenon of "orphan" transfer orders, grant sufficient reassurance to market counterparties to allow them to return assets promptly to their brokerage and settlement agency clients.

(iv) Manual re-entry of settlement instructions

4.22 It may be time-consuming and operationally challenging for an administrator of the insolvent estate and the settlement counterparty to re-input all relevant settlement instructions where a party to an unsettled trade has become insolvent. However, the FMLC would argue that any such difficulties are outweighed by the benefits of certainty that this proposal would bring to trading counterparties and to market participants in general.

4.23 There may nevertheless be practical restrictions on the ability of administrators to re-input settlement instructions where the IT systems of the insolvent firm are down. When LBIE became insolvent, its IT function collapsed and the failure of this function materially affected the ability of administrators to address issues around open client positions. Market and regulatory action may offer the principal means of ensuring that arrangements are organised so that an administrator would be able to continue to operate such systems, but this would be difficult to enforce where the service provider is based in another jurisdiction or the relevant contract is not governed by English law. Legislation cannot by itself, therefore, solve this problem.

5. Implementation of Solution

5.1 A shift to the alternative approach to dealing with settlement instructions can be implemented through an appropriate amendment to EUI's contractual documentation and CREST Rule 13 (which, amongst other things, sets out

EUI's "default arrangements" for the purposes of the SF Regulations). EUI has the power to amend the CREST Rules pursuant to clause 19 of its CREST member terms and conditions, subject to its complying with the applicable prior consultation procedures set out in the CREST Manual, and provided that the revised rules satisfy the purposes and requirements of the relevant UK and European legislation. This latter requirement is considered further below but, in short, the FMLC considers that the purposes of applicable legislation would be more transparently seen to be fulfilled by the implementation of the proposed amendment to the CREST Rules than they are at present. The applicable legislation in this context is the following:

a) *Financial Services and Markets Act (Recognition Requirements for Investment Exchanges and Clearing Houses) 2001*

EUI is a recognised clearing house in the UK and, as such, must satisfy the requirements contained in the *Financial Services and Markets Act (Recognition Requirements for Investment Exchanges and Clearing Houses) 2001*, which are reflected in the FSA Handbook.[31] These requirements impose an obligation on the recognised clearing house to "ensure that its facilities are such as to afford proper protection to investors".[32] This obligation would, in the FMLC's view, be better served by a non-discretionary procedure in the CREST Rules which provides for the automatic and immediate termination of matched but unsettled trades (both on exchange and OTC) where the CREST participant has become insolvent.

b) *Financial Markets and Insolvency (Settlement Finality) Regulations 1999*

The CREST system has also been designated in the UK by the FSA pursuant to the SF Regulations, which implement the SFD. As a result, EUI was required to satisfy the FSA (and the FSA was and is satisfied) that the CREST rules meet the general obligations of the schedule to these regulations, which include a requirement that they contain "default arrangements which are appropriate…in all the circumstances".[33] A move to the alternative model of "neutralising" transfer orders relating to outstanding trades following an insolvency event should, in the view of the FMLC, enhance market confidence in EUI's default arrangements, since it would increase transparency, predictability and certainty in the procedures that EUI would operate to minimise the disruption caused by the default of a participant.

c) *The Uncertificated Securities Regulations 2001*

The FMLC understands that EUI would be willing to support further amendment to CREST Rule 13, as proposed here, provided that HM Treasury takes the view that it is a suitable policy measure. EUI believes that statutory support for the amendment is desirable in the form of an addition to the *Uncertificated Securities Regulations 2001* (the "USRs"), so that the exception to interfering with dematerialised instructions is expanded to permit the

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31 See the chapter of the FSA Handbook headed, "Recognised Investment Exchanges and Recognised Clearing Houses"

32 Paragraph 19(1) of the Schedule to the *Financial Services and Markets Act (Recognition Requirements for Investment Exchanges and Clearing Houses) 2001*

33 Paragraph 6 of the Schedule

operator of the settlement system to interfere with such instructions, in the manner proposed by the FMLC, where a member of the settlement system has become insolvent. HM Treasury has the power to amend the USRs under the *Companies Act 2006*.[34]

If, however, HM Treasury does not consider that the powers under the *Companies Act 2006* extend to its amending the USRs in this way, it is possible for HM Treasury to use the powers conferred upon it by section 2(2) *European Communities Act 1972* to re-implement the USRs so that they make explicit that the proposed method of interference with dematerialised instructions by the operator of a settlement system is permitted.[35] HM Treasury would have to be satisfied that the purpose of the proposed change to the USRs is to deal with "matters arising out of or related to" the rights and obligations conferred by the SFD.[36] Since it would facilitate an amendment to the CREST Rules which would better allow the purposes of the SFD to be fulfilled, this should not prove problematic.

6. Conclusion

6.1 The position of unsettled OTC trades after the LBIE collapse created considerable uncertainty amongst market counterparties regarding their settlement and other risks; and the negative impact upon market confidence potentially adversely affects the systemic integrity of the wholesale markets. It is therefore essential that changes are made to respond to the concerns expressed by certain key market participants so as to ensure that there is greater transparency and *ex ante* certainty as to the UK market's likely response to the problem of unsettled OTC trades of an insolvent major financial institution.

6.2 Whilst it is acknowledged that there are certain drawbacks to the proposed solution, the FMLC considers that it would provide the market with a much clearer and more certain position in the event of future market participant default and restore confidence in the operation of the wholesale markets and its systems in times of extreme stress. In particular, it would more transparently enable counterparties in any future default scenario to manage their market, settlement and other risks and ease compliance with their regulatory obligations.

6.3 The FMLC also notes that participants in many cash equities and fixed income markets around the world faced similar uncertainty concerning the settlement of their OTC trades when LBIE became insolvent. It should therefore be considered whether changes to the operation of other settlement systems are also needed. The FMLC envisages that, ideally, its approach might be used as a template against which to measure potential changes to such systems. This,

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[34] Sections 784, 785, 788, 1292 and 1294

[35] HM Treasury is the government department designated for the purposes of section 2(2) of the *European Communities Act 1972* in relation to the transfer of securities without a written instrument pursuant to the *Companies Act 2006* and *SI 1992/1315*. It is also worth noting that there is precedent for HM Treasury using the powers conferred upon it by the *European Communities Act* on a stand-alone basis to amend secondary legislation. For example, the definition of "financial instrument" in section 89F *Financial Services and Markets Act 2000* was amended by an order made under section 2(2) of the *European Communities Act 1972.*

[36] Section 2(2)(b) *European Communities Act 1972*

in turn, might result in the adoption of a more consistent approach generally to the processing of settlement instructions, which would significantly reduce the complexity surrounding the international trading and settlement of OTC trades both for market participants and for the insolvency office-holders appointed to insolvent participants.

APPENDIX ONE
CONTRACTUAL ANALYSIS OF OTC TRADES

Market Practice for formation of OTC trades

This appendix sets out some of the mechanics by which contracts are formed and by which specific contractual terms might be incorporated in respect of trades in securities (principally in the OTC cash equities and fixed income bond markets). It does not purport to be a comprehensive overview by any means. A small number of experienced traders covering both agency and principal trading in London cash equities and bond markets were spoken to in order to collate this information. The appendix also contains reference to bilateral, essentially *ad hoc*, post-trade arrangements which trading counterparties may agree with each other and with their settlement agents.

The large majority of trades in London for bonds and for cash equities are executed over the telephone or via brief electronic message (e.g. by using a commercially available messaging service such as Bloomberg). Generally, the only terms agreed are the price, quantity and security name, and the settlement date and venue are assumed. Nevertheless, there are pockets of practice where specific contractual terms are agreed including, for example, in the markets for secured and distressed debt and where a party seeks to address the creditworthiness of its counterparty by way of a "give up" agreement. It is also possible to execute trades in a way which provides the parties with scope for prescribing specific contractual terms, if not *in extenso*, then at least by reference (such as message templates used in trade messaging or trade routing systems).

Further details of each of these trading practices are provided below.

1. Cash equities and fixed income bonds trading OTC

   Both for cash equities and fixed income bonds trading OTC, the overwhelming practice is to trade by telephone or electronic messaging. Items agreed at the point of execution will, in the vast majority of cases, be quantity, price, and security name. The settlement date will be assumed to be three business days after the trade is agreed. Location or manner of settlement will not generally be stipulated.[37]

2. Give Up Agreement

   Bond traders would expect to document post-trade arrangements only if there is concern as to the creditworthiness of an execution counterparty, in which case the settlement agent or prime broker for that executing firm may offer to stand, effectively as principal, in the shoes of the executing firm in order to discharge its post-trade obligations. This is generally done by means of a "give up agreement" in which both the counterparties to the trade as well as their respective settlement agents or prime brokers enter into an agreement committing the relevant settlement agents or prime brokers to settle with each

[37] Unless, in either case, there is a departure from the usual standard arrangements for settlement for that security type.

other within certain parameters. Give up agreements do not usually contain any default provisions. A slightly fuller version of this type of document includes a right to terminate and recover damages if the counterparty has committed an event of default or become insolvent, but the effects on settlement of outstanding trades are not specified.

Whether a settlement give up agreement could be amended to include a legal reference to a settlement protocol dealing with insolvency events and, correspondingly, whether the LIBA protocol could be extended to cover parties to related "give up agreements" is beyond the remit of this paper. But the FMLC is of the view that further efforts to accommodate complex agency relationships within the protocol would be valuable.

3. Markets using Standard Contract Terms

The market in secured debt trading – at par or as distressed debt – trades on the basis of full and usually standardised terms and conditions. Models for these are provided by the Loan Market Association and they include delayed settlement compensation and default arrangements. The secured and distressed debt markets are considered to be something of an anomaly and are known for the extent of paperwork required, most of which is completed some time after the trade has been executed.

4. Other Trade Messaging

Firms trading OTC cash equities or fixed income may use commercially available order routing systems which provide for a wide range of information to be exchanged between traders at the point of execution. In practice, traders focus on the quantity, price, security name and settlement date when trading OTC on the telephone and may fill in (or amend on a standard template) only these fields. However, it is possible to include a wider set of trade data using "tags" or fields provided by the vendor. There is no uniform set of fields available but, in any event, the fields are brief and highly factual and include a number of spaces for data related more to placing of orders with the broker than to execution by him. The instructions entered into these systems are not used to include references to, nor do they provide for, incorporation of standard contractual terms.

Finally, as discussed above, traders may also send an electronic message using a third party provider system such as Bloomberg in order either to confirm a trade or to provide an audit trail. The principal information provided is likely to be security name, quantity and price as above, but the message may also include a specific legend which sets out the purpose of the relevant trade (for example, as a hedge in connection with a contract for differences). It would be possible to include references to standard terms in the spaces for the legend as these invite free text entries, but this is not market practice.

5. OTC Derivatives

OTC derivatives trades are frequently conducted on the basis of documentation agreed in advance between the parties. ISDA (the

International Swaps and Derivatives Association) has provided standard form documentation for the trading of contracts for differences and swaps and this same documentation is sometimes used for other types of trade. Market take-up of these standard terms is widespread. Many derivatives trades are also conducted on bespoke terms agreed in advance between the parties.

Legal enforceability of OTC trades

As set out above, it is common practice for traders carrying out OTC trades simply to agree quantity, price, and security name orally over the telephone or by electronic message. It is, however, vital from the perspective of contractual certainty that the contractual status of such agreements and the extent to which they give rise to legally enforceable obligations is ascertainable.

The financial markets thus rely heavily on legal doctrine which establishes that a contract does not always need to be in written form. Whilst a transfer of shares is required by law to be evidenced by a written contract under s770 *Companies Act 2006*, a share transfer in CREST can be effected electronically and will not require a written transfer.[38] Therefore, OTC trades concluded over the telephone which relate to shares in CREST are capable of being legally enforceable contracts without having to be evidenced by a written contract under s770 *Companies Act 2006*.

The legality of trades agreed over the telephone was specifically considered in the case of *Bear Stearns Bank plc v Forum Global Equity Ltd*[39] and the following observations were made in the judgment:

(a) an agreement is not contractually concluded if it leaves significant matters subject to future agreement. It was noted by the judge, however, that there is no legal obstacle to parties agreeing to be bound while deferring important matters to be agreed at a later date. This implies that only agreeing minimal details of a trade is sufficient so long as the significant details are agreed.

(b) the fact that the parties to a trade did not agree a settlement date did not make the agreement too uncertain to be enforced since, in the absence of express agreement, there was an implied term that the parties would complete the transaction within a reasonable time.

(c) the agreement was not void or unenforceable on the grounds that the parties had not agreed on the form of purchase or stipulated any representations and warranties.

(d) for the parties to avoid a binding contract, they would have to say something explicit to that effect.

Collectively, these points establish that very few details need to be agreed upon for traders to fulfil the minimum requirements for a contract in relation to OTC trades.

[38] Sections 783, 784(3), 785 and 788 CA 2006; and The Uncertified Securities Regulations 2001 (SI 2001/3755).
[39] [2007] EWHC 1576 (Comm)

APPENDIX TWO
TRADE AND SETTLEMENT LIFE CYCLE OF OTC CASH EQUITY TRADE

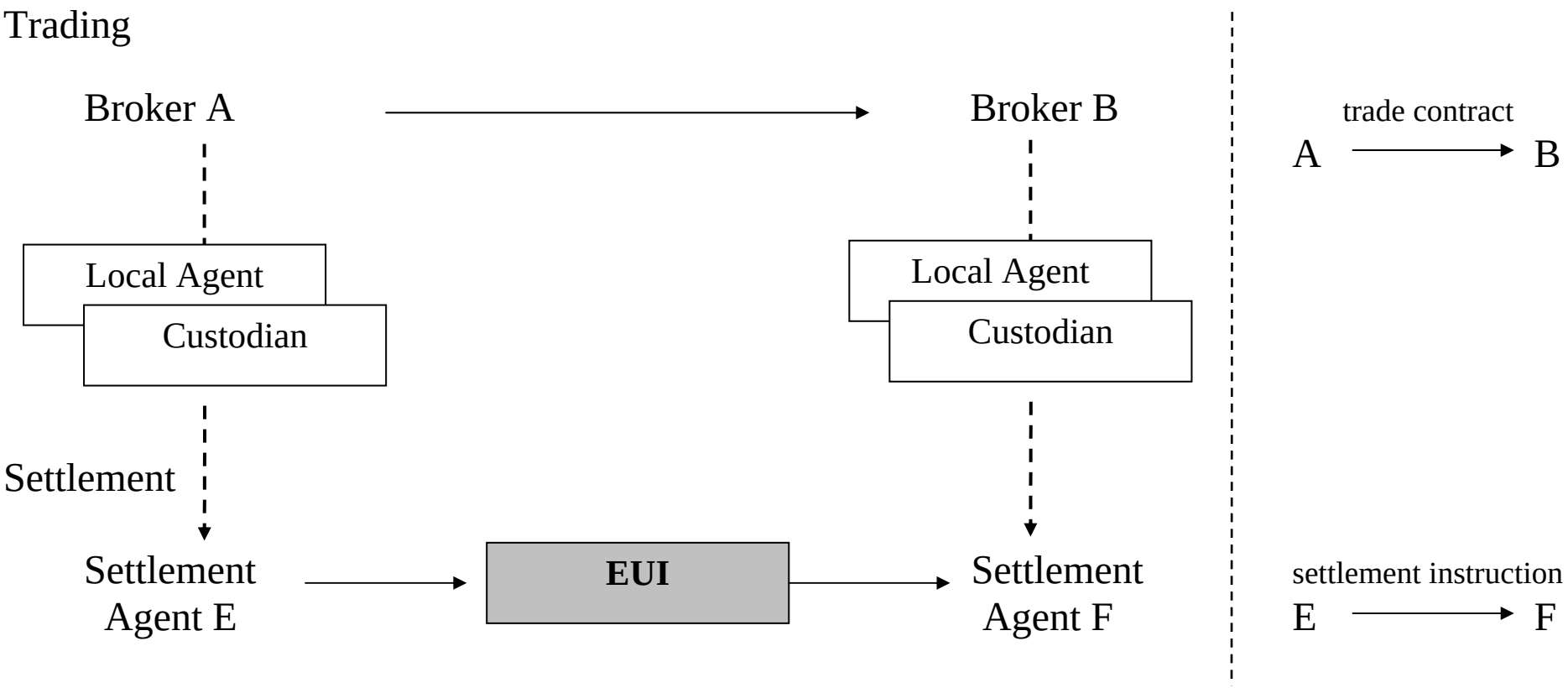

Chart provided by Euroclear (2009)

APPENDIX THREE
GUIDANCE FOR CREST RULE 13 AND FMLC COMMENTARY

Guidance for CREST Rule 13

Note: EUI can be expected to take the following actions under its default arrangements in the event that it is notified that insolvency proceedings have commenced against a CREST member (a "defaulting participant").

References in this Note to "initial disablement" are to the time at which EUI suspends the participation of a defaulting participant in accordance with paragraph 1 below (or the time that EUI receives notification that insolvency proceedings have commenced, if the defaulting participant's participation had already been suspended).

References in this Note to an "affected transfer order" is to an unsettled transfer order in the CREST UK system or the CREST Irish system, that entered the system prior to the commencement of the insolvency proceedings against the defaulting participant, which is either attributable or addressed to the defaulting participant.

1. Initial disablement

   Unless a defaulting participant's participation is already suspended, EUI will in normal circumstances immediately suspend its participation on receiving notification that insolvency proceedings have commenced against the defaulting participant. This will result in all settlement involving the defaulting participant immediately being suspended.

2. Conditions for re-enablement

   EUI will not re-enable the defaulting participant's participation, unless EUI is satisfied that:

   (a) systemic or other types of risk that arise by reason of the participation of the defaulting participant in the CREST UK system or the CREST Irish system would be limited or otherwise mitigated by re-enabling its participation;

   (b) such re-enablement, and any settlement which may be effected as a result of such re-enablement, will not cause EUI to be in breach of any direction or requirement of any regulatory authority or body to whose jurisdiction it is subject;

   (c) such re-enablement, and any settlement which may be effected as a result of such re-enablement, will be consistent with the effect and operation of the default rules (within the meaning of Part VII of the *Companies Act 1989*) of any relevant exchange or clearing house;

   (d) such re-enablement, and any settlement which may be effected as a result of such re-enablement, can be effected without material

interference with or disruption to the efficient operation of the CREST UK system or the CREST Irish system; and

(e) the defaulting participant (or its insolvency office-holder) has complied with all requirements and conditions that may be imposed by EUI pursuant to its agreement with the defaulting participant, the CREST Manual and/or the CREST Rules as a condition to re-enablement.

3. Participant to be re-enabled

If the conditions set out in paragraph 2 are met and EUI proposes to re-enable the participation of the defaulting participant, it will promptly notify participants by way of Operational Bulletin (an "Indicative Operational Bulletin") of its intention to do so.

Such Indicative Operational Bulletin will be issued within five (5) business days following initial disablement.

EUI will, where possible at that time, specify in the Indicative Operational Bulletin the period within which EUI intends to re-enable the participation of the defaulting participant. Such re-enablement shall be at least one (1) business day from the date of issue of the Indicative Operational Bulletin.

4. Participant not to be re-enabled

Where EUI concludes that the conditions set out in paragraph 2 will not be met, EUI will promptly (and in any event at the latest within five (5) business days following initial disablement) notify participants by way of an Operational Bulletin (a "Permanent Suspension Operational Bulletin") that the participation of the defaulting participant will remain disabled and settlement of all affected transfer orders will be permanently suspended.

By way of example, where a defaulting participant has been declared in default under the default rules (within the meaning of Part VII of the *Companies Act 1989*) of a relevant exchange or clearing house, trades in relation to the defaulting participant may have been "closed out" under those default rules. Re-enablement of the defaulting participant and settlement of affected transfer orders is likely to be inconsistent with such close out arrangements (ie the condition in paragraph 2(c) above will not be satisfied) and EUI can therefore be expected to issue a Permanent Suspension Operational Bulletin promptly after such a declaration of default.

5. Direction to delete affected transfer orders

If:

(a) ten (10) business days following re-enablement of a defaulting participant's participation in accordance with an Indicative Operational Bulletin, affected transfer orders remain in the CREST UK system or the CREST Irish system; or

(b) EUI has issued a Permanent Suspension Operational Bulletin and affected transfer orders remain in the CREST UK system or the CREST Irish system,

then EUI will issue a direction by Operational Bulletin (a "Directing Operational Bulletin") to the defaulting participant and each settlement counterparty to any affected transfer order that at the time of issue of the Directing Operational Bulletin remains unsettled in the CREST UK system or the CREST Irish system (a "relevant affected transfer order").

In the case of 5(a) above, EUI will suspend the participation of the defaulting participant and issue such Directing Operation Bulletin.

In the case of 5(b) above, such Directing Operational Bulletin will be issued no later than ten (10) business days after the issuance of the Permanent Suspension Operational Bulletin.

6. Directing Operational Bulletins

A Directing Operational Bulletin shall (amongst other things):

(a) be issued under and as part of its default arrangements designated as such by EUI for the purposes of paragraph 6.1.6 of this CREST Rule 13;

(b) require the defaulting participant (or its insolvency office-holder) and the relevant settlement counterparty to:

(i) input instructions into CREST to match delete all relevant affected transfer orders as soon as is reasonably practicable, but in any event by no later than close of business on a date that shall not be more than ten (10) business days after the date of issue of the Directing Operational Bulletin;

(ii) take all such other steps available to it within the system to prevent the settlement of relevant affected transfer orders at any time prior to their matched deletion in accordance with EUI's direction; and

(c) state that any failure to comply with the direction shall constitute a breach of a CREST Requirement (for the purposes of the relevant participant's contract with EUI) and may result in the disablement of the CREST participant concerned.

7. Variations of timing

If EUI proposes to vary any action or timing outlined in this Note, it will (where practicable and where it is able to do so) promptly notify participants by Operational Bulletin of any such variation.

This may occur, for example, where EUI is satisfied that relevant participants are proceeding or will proceed voluntarily to match delete affected transfer orders without being compelled to do so by direction.

FMLC Commentary on Guidelines

The FMLC believes that there are ways in which the guidance falls short, post-Lehman, of ensuring wider confidence in the UK market infrastructure's likely response to the default of a major financial institution. The FMLC recognises that the permissive and discretionary language of the guidance is consistent with the fact that the rule establishes EUI's default powers delegated to it by or under statute (i.e. the SF Regulations). In exercising its quasi-public law powers, EUI will be discharging regulatory functions and, as such, the language reflects its concern that it should not be unduly fettered in the action that it might wish to take, in the circumstances of a particular insolvency, to mitigate the adverse impact upon its system and system-participants as a result of the default of a CREST member.

However, the FMLC believes that, in the light of concerns expressed to it by certain key market participants after the LBIE collapse, continuing market confidence requires greater *ex ante* certainty in the steps that EUI will take to deal with outstanding settlement instructions attributable to an insolvent CREST participant. The loss of flexibility for EUI to determine the appropriate action to take in response to a particular defaulting participant (after consultation with the FSA and other regulatory authorities) is a necessary price to ensure the required level of legal and operational certainty for the wider market.

APPENDIX FOUR
LIBA DRAFT DEFAULT PROTOCOL – OTC CASH EQUITY TRADES

1. INTRODUCTION

1.1 This default protocol (the ***Protocol***) is published by the London Investment Banking Association (***LIBA***). Its purpose is to allow parties to adhere to a set of standard default provisions in circumstances where cash equities trades are not otherwise subject to the default rules of a regulated market, multilateral trading facility or similar venue, and where the parties have not themselves separately agreed express provisions that would apply upon the default of one of the parties to the trade.

1.2 The default provisions of the Protocol may be applied to [equity] trades covered by this Protocol (as defined below) by a party that has adhered to the Protocol (an ***Adhering Party***) upon the occurrence of an insolvency-related default of another Adhering Party.

1.3 Parties may adhere to the Protocol and be bound by its terms by following the adherence procedure described in Section 2 below. This Protocol is intended to create legal rights and obligations and parties are encouraged to take legal advice on its terms and effect before adhering to the Protocol.

2. ADHERENCE

2.1 Adherence to the Protocol will be limited to persons falling within the following categories:

(a) Investment Firms;

(b) Credit Institutions;

(c) Equivalent Third Country Firms;

(d) [any other legal person who trades in equity securities on a professional and regular basis].

2.2 Adherence to the Protocol will be evidenced through electronic acceptance of the terms of the Protocol via a website hosted and operated by a third party provider (the ***Administrator***) [*website address*] (the ***Adherence Confirmation***).

2.3 A party will become an Adhering Party to this Protocol with effect from the entry of the party's name on the list of Adhering Parties maintained by the Administrator and published on its website.

2.4 The terms set out in this Protocol will be effective as between any two Adhering Parties from the time they become Adhering Parties.

2.5 An Adhering Party may withdraw its adherence to the Protocol at any time by electronic notification via the Administrator's website (the ***Withdrawal Confirmation***).

2.6 Subject to paragraph [2.7] below, an Adhering Party will cease to be an Adhering Party (and will become a ***Former Adhering Party***) with effect from the removal of the Adhering Party's name from the list of Adhering Parties maintained by the Administrator on its website.

2.7 The terms of this Protocol will continue to apply between an Adhering Party and a Former Adhering Party in respect of Covered Trades entered into prior to that party becoming a Former Adhering Party.

3. REPRESENTATIONS.

3.1 Each Adhering Party represents to each other Adhering Party on a continuing basis that:

(a) it is duly incorporated and validly existing under the laws of its country of incorporation or formation;

(b) it is duly authorised and empowered to execute and deliver the Adherence Confirmation and to perform its duties and obligations under this Protocol;

(a) the execution and delivery of this Protocol will not:

(i) conflict with or result in a breach of any of the terms or provisions of, or constitute a default under, the documents constituting the Adhering Party, or any indenture, trust deed, mortgage or other agreement or instrument to which the Adhering Party is a party or by which it or any of its assets is bound;

(ii) infringe any existing applicable law, rule, regulation, judgment, order or decree of any government, governmental body, regulatory body or court, domestic or foreign, having jurisdiction over the Adhering Party or any of its assets;

(c) it has all necessary licences and approvals, and is duly authorised and empowered, to perform its duties and obligations under this Agreement and will do nothing prejudicial to the continuation of such authorisation, licences or approvals;

(d) this Protocol constitutes the legal, valid, binding and enforceable obligations of the Adhering Party and is enforceable in accordance with its terms.

4. DEFINITIONS AND INTERPRETATION

4.1 In this Protocol the following terms shall have the following meanings:

Act of Insolvency means in relation to an Adhering Party

(a) its making a general assignment for the benefit of, or entering into a reorganisation, arrangement, or composition with creditors; or

(b) its stating in writing that it is unable to pay its debts as they become due; or

(c) its seeking, consenting to or acquiescing in the appointment of any trustee, administrator, receiver or liquidator or analogous officer of it or any material part of its property; or

(d) the presentation or filing of a petition in respect of it in any court or before any agency alleging or for the bankruptcy, winding-up or insolvency of such Adhering Party (or any analogous proceeding) or seeking any reorganisation, arrangement, composition, re-adjustment, administration, liquidation, dissolution or similar relief under any present or future statute, law or regulation, such petition not having been stayed or dismissed within 30 days of its filing (except in the case of a petition for winding-up or any analogous proceeding in respect of which no such 30 day period shall apply); or

(f) the appointment of a receiver, administrator, liquidator or trustee or analogous officer of such Adhering Party over all or any material part of such Adhering Party's property; or

(g) the convening of any meeting of its creditors for the purpose of considering a voluntary arrangement as referred to in Section 3 of the Insolvency Act 1986 (or any analogous proceeding);

Adhering Party means a party that has adhered to this Protocol in accordance with the provisions of Section 2;

Administrator means [ ];

Appropriate Market means, in relation to Securities, the market which is the most appropriate market for securities of that description, as determined by the Non Defaulting Party;

Base Currency means the base currency selected by the Non Defaulting Party;

Business Day means a day, other than a Saturday or Sunday, on which banks are generally open for business in [London];

Covered Trade means a contract for the purchase and sale of [equity] securities for settlement by delivery of the equity security which is:

(a) not entered into on, or under the rules of, a Regulated Market, MTF or Equivalent Third Country System that has default rules that would apply to determine the parties' rights and obligations under the contract upon or following the occurrence of a Default Event;

(b) not subject to the rules of a central counterparty or other clearing system that has default rules that would apply to determine the parties' rights and obligations under the contract upon or following the occurrence of a Default Event; or

(c) not subject to binding terms between the Defaulting Party and Non-Defaulting Party (other than this Protocol) that would apply to

determine the parties' rights and obligations under the contract upon or following the occurrence of a Default Event,

and in each case where the contract has not yet been performed by the transfer of the relevant [equity] securities against the payment of the purchase price;

Credit Institution has the meaning given in Article 4(23) of MiFID;

Default Event means an Act of Insolvency affecting an Adhering Party;

Default Market Value means the value of securities calculated in accordance with paragraphs [5.5] to [5.6];

Default Notice has the meaning given in paragraph [5.1];

Default Valuation Notice has the meaning given in paragraph [5.5];

Default Valuation Time means the close of business in the Appropriate Market on the [tenth] dealing day after the Termination Date;

Defaulting Party has the meaning given in paragraph [5.1];

Deliverable Securities means Securities to be delivered by the Defaulting Party;

Equivalent Third Country Firm means a firm that would be an Investment Firm or a Credit Institution if it had its head office in the European Economic Area;

Equivalent Third Country System means a multilateral securities trading system that is equivalent to an MTF or Regulated Market established outside of the European Economic Area;

Former Adhering Party has the meaning given in paragraph [2.6];

Investment Firm has the meaning given in Article 4(1) of MiFID;

MiFID means Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments;

MTF has the meaning given in Article 4(15) of MiFID;

Net Value means at any time, in relation to any Deliverable Securities or Receivable Securities, the amount which, in the reasonable opinion of the Non Defaulting Party, represents their fair market value, having regard to such pricing sources and methods (which may include, without limitation, available prices for securities with similar maturities, terms and credit characteristics as the relevant Securities) as the Non Defaulting Party considers appropriate, less, in the case of Receivable Securities, or plus, in the case of Deliverable Securities, all Transaction Costs which would be incurred in connection with the purchase or sale of such securities;

Non-Defaulting Party has the meaning given in paragraph [5.1];

Receivable Securities means securities to be received by the Defaulting Party;

Regulated Market has the meaning given in Article 4(14) of MiFID;

Securities means the securities that are to be delivered under a Covered Trade;

Termination Balance has the meaning given in paragraph [5.3(c)];

Termination Date means the date of service of the Default Notice under paragraph [5.1];

Transaction Costs means, in relation to any transaction contemplated in paragraph [5.5], the reasonable costs, commissions (including internal commissions), fees and expenses (including any mark-up or mark-down or premium paid for guaranteed delivery) that would be incurred in connection with the purchase of Deliverable Securities or sale of Receivable Securities, calculated on the assumption that the aggregate thereof is the least that could reasonably be expected to be paid in order to carry out the transaction.

4.2 In this Protocol unless the context requires otherwise:

(a) the headings are inserted for convenience only and do not affect the construction of the Agreement;

(b) references to one gender includes all genders;

(c) references to the singular include references to the plural;

(d) any reference to an enactment or statutory provision is a reference to it as it may have been, or may from time to time be amended, modified, consolidated or re-enacted;

(e) references in this Protocol to any English legal term for any action, remedy, method of judicial proceedings, legal document, legal status, court official or any other legal concept is, in respect of any jurisdiction other than England and Wales, deemed to include the legal concept or term which most nearly approximates in that jurisdiction to the English legal term.

5. DEFAULT TERMS

5.1 Upon or following the occurrence of a Default Event affecting an Adhering Party (the ***Defaulting Party***) each other Adhering Party (the ***Non-Defaulting Party***) which is a party to a Covered Trade with the Defaulting Party may serve a notice (a ***Default Notice***) on the Defaulting Party.

5.2 Upon service of a Default Notice the provisions of sub-paragraphs [5.3] to [5.11] shall apply as between the Defaulting Party and Non-Defaulting Party.

5.3 In respect of all Covered Trades the delivery and payment obligations of the Defaulting and Non-Defaulting Parties shall be effected only in accordance with the following provisions:

(a) the Default Market Value of the securities to be delivered and the value of the cash to be paid under the Covered Trades shall be established by the Non-Defaulting Party;

(b) on the basis of the sums so established, an account shall be taken by the Non-Defaulting Party as at the Termination Date of what is due from each party to the other (on the basis that a party's claim for delivery of Securities in respect of a Covered Trade equals the Default Market Value of those Securities);

(c) the sums due from one party shall be set off against the sums due from the other and only the balance of the account (the ***Termination Balance***) shall be payable (by the party having the party having the claim valued at the lower amount);

(d) the Non-Defaulting Party shall notify the Defaulting Party of the Termination Balance as soon as possible and in any event [within one Business Day of its calculation];

(e) the Termination Balance shall be payable on the Business Day following the its calculation by the Non-Defaulting Party;

(f) for the purpose of the calculations required by this paragraph [5.3] any sums not denominated in the Base Currency shall be converted into the Base Currency on the relevant date at the spot rate prevailing at the relevant time as determined by the Non-Defaulting Party in its commercially reasonable discretion.

5.4 For the purposes of this Protocol, the Default Market Value of securities shall be calculated in accordance with paragraphs [5.5] to [5.6]:

5.5 If between the Default Event and the Default Valuation Time (or as soon as reasonably practicable thereafter) the Non-Defaulting Party gives the Defaulting Party a written notice (a ***Default Valuation Notice***) which:

(a) states that since the occurrence of the relevant Default Event, the Non Defaulting Party has sold, in the case of Receivable Securities, or purchased, in the case of Deliverable Securities, securities which form part of the same issue and are of an identical type and description as the Securities, and that the Non Defaulting Party elects to treat as the Default Market Value:

(i) in the case of Receivable Securities, the net proceeds of such sale after deducting all reasonable costs, commissions (including internal commissions) fees and expenses incurred in connection therewith; provided that, where the securities sold are not identical in amount to the Securities, the Non Defaulting Party may, acting in good faith, either (A) elect to treat such net proceeds of sale divided by the amount of securities sold and multiplied by the amount of the Securities as the Default Market Value or (B) elect to treat such net proceeds of sale of the securities actually sold as the Default Market Value of that proportion of the Securities, and, in the case of (B), the Default Market Value of the balance of the Securities shall be determined separately in

accordance with the provisions of this paragraph [5.5] and accordingly may be the subject of a separate notice (or notices) under this paragraph [5.5]; or

(ii) in the case of Deliverable Securities, the aggregate cost of such purchase, including all reasonable costs, commissions (including internal commissions) fees and expenses incurred in connection therewith; provided that, where the securities purchased are not identical in amount to the Securities, the Non Defaulting Party may, acting in good faith, either (A) elect to treat such aggregate cost divided by the amount of securities purchased and multiplied by the amount of the Securities as the Default Market Value or (B) elect to treat the aggregate cost of purchasing the securities actually purchased as the Default Market Value of that proportion of the Securities or, and, in the case of (B), the Default Market Value of the balance of the Securities shall be determined separately in accordance with the provisions of this paragraph [5.5] and accordingly may be the subject of a separate notice (or notices) under this paragraph [5.5],

(for the avoidance of doubt, the Non-Defaulting Party shall have sole and absolute discretion as to the manner and timing of any sales or purchases of securities which form part of the same issue and are of an identical type and description as the Securities);

(b) states that the Non Defaulting Party has received, in the case of Deliverable Securities, offer quotations or, in the case of Receivable Securities, bid quotations in respect of securities of the relevant description from two or more market makers or regular dealers in the Appropriate Market in a commercially reasonable size (as determined by the Non Defaulting Party) and specifies:

(i) the price or prices quoted by each of them for, in the case of Deliverable Securities, the sale by the relevant market marker or dealer of such securities or, in the case of Receivable Securities, the purchase by the relevant market maker or dealer of such securities, provided that such price or prices quoted may be adjusted in a commercially reasonable manner by the Non Defaulting Party to reflect accrued but unpaid dividends not reflected in the price or prices quoted in respect of such securities;

(ii) the Transaction Costs which would be incurred in connection with such a transaction; and

(iii) that the Non Defaulting Party elects to treat the price so quoted (or, where more than one price is so quoted, the arithmetic mean of the prices so quoted), as adjusted in accordance with (i) above if relevant, and after deducting, in the case of Receivable Securities, or adding, in the case of Deliverable Securities, such Transaction Costs, as the Default Market Value of the relevant Securities; or

(c) states:

(i) that either (A) acting in good faith, the Non Defaulting Party has endeavoured but been unable to sell or purchase securities in accordance with sub paragraph (a) above or to obtain quotations in accordance with sub paragraph (b) above (or both) or (B) the Non Defaulting Party has determined that it would not be commercially reasonable to sell or purchase securities at the prices bid or offered or to obtain such quotations, or that it would not be commercially reasonable to use any quotations which it has obtained under sub paragraph (b) above; and

(ii) that the Non Defaulting Party has determined the Net Value of the relevant Securities (which shall be specified) and that the Non Defaulting Party elects to treat such Net Value as the Default Market Value of the relevant Securities,

then the Default Market Value of the relevant Securities shall be an amount equal to the Default Market Value specified in accordance with (a), (b)(iii) or, as the case may be, (c)(ii) above.

5.6 If by the Default Valuation Time the Non Defaulting Party has not given a Default Valuation Notice, the Default Market Value of the relevant Securities shall be an amount equal to their Net Value at the Default Valuation Time; provided that, if at the Default Valuation Time the Non Defaulting Party reasonably determines that, owing to circumstances affecting the market in the Securities in question, it is not reasonably practicable for the Non Defaulting Party to determine a Net Value of such Securities which is commercially reasonable (by reason of lack of tradable prices or otherwise), the Default Market Value of such Securities shall be an amount equal to their Net Value as determined by the Non Defaulting Party as soon as reasonably practicable after the Default Valuation Time.

5.7 [If an Adhering Party serves a Default Notice under paragraph [5.1] the Non Defaulting Party and the Defaulting Party shall, where permitted by the relevant settlement system, use their reasonable endeavours to remove settlement instructions in respect of the Covered Trades between them from the relevant settlement system to prevent such trades from settling after service of a Default Notice.][40]

5.8 The Defaulting Party shall be liable to the Non Defaulting Party for costs, losses, charges, damages, fees and expenses incurred by the Non Defaulting Party in connection with or as a consequence of a Default Event including buy-in costs in respect of any Covered Trades and all reasonable legal and other professional expenses incurred by the Non-Defaulting Party. Any claim by the Non Defaulting Party for such costs, losses, charges, damages, fees and expenses may be added to the Termination Balance.

5.9 For all purposes, including legal proceedings, a statement of the Termination Balance due signed by an authorised officer of the Non Defaulting Party shall be conclusive and binding on the Non Defaulting Party in the absence of manifest error.

5.10 [*Tax eg SDRT costs on terminated trades?*]

[40] This would need to be amended to be consistent with the approach adopted by CREST for the removal of unsettled trades.

5.11 In the event of either party failing to remit sums in accordance with this Protocol such party hereby undertakes to pay to the other party upon demand interest (before as well as after judgment) on the net balance due and outstanding, for the period commencing on and inclusive of the original due date for payment to (but excluding) the date of actual payment, in the same currency as the principal sum and at the overnight London Inter Bank Offered Rate as quoted on a reputable financial information service (***LIBOR***). Interest will accrue daily on a compound basis and will be calculated according to the actual number of days elapsed. No interest shall be payable under this paragraph in respect of any day on which one Party endeavours to make a payment to the other Party but the other Party is unable to receive it.

6. NO WAIVER

6.1 No failure or delay by an Adhering Party (whether by course of conduct or otherwise) to exercise any right, power or privilege under this Protocol shall operate as a waiver thereof nor shall any single or partial exercise of any right, power or privilege preclude any other or further exercise thereof or the exercise of any other right, power or privilege as herein provided.

7. NOTICES

7.1 Any notice or other communication to be given by one Adhering Party to another in respect of this Protocol may be given in any manner set forth below to the address or number for the relevant Adhering Party or in accordance with the electronic messaging system details in each case as set out on the Administrator's website and will be deemed effective as indicated:

(a) if in writing and delivered in person or by courier, on the date it is delivered;

(b) if sent by facsimile transmission, on the date that transmission is [received] by a responsible employee of the recipient in legible form (it being agreed that the burden of proving receipt will be on the sender and will not be met by a transmission report generated by the sender's facsimile machine);

(c) if sent by certified or registered mail (airmail, if overseas) or the equivalent (return receipt requested), on the date that mail is delivered or its delivery is attempted; or

(d) if sent by electronic messaging system, on the date that electronic message is received,

unless the date of that delivery (or attempted delivery) or the receipt, as applicable, is not a Business Day or that communication is delivered (or attempted) or received, as applicable, after the close of business on a Business Day, in which case that communication shall be deemed given and effective on the first following day that is a Business Day.

7.2 An Adhering Party may change the address or facsimile number or electronic messaging system details at which notices or other communications are to be given to it by notifying the Administrator via its website of its amended details.

8. RIGHTS OF THIRD PARTIES

8.1 A person who is not an Adhering Party has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce any terms of this Protocol, but this does not affect any right or remedy of a third party which exists or is available apart from that Act.

9. AMENDMENTS

9.1 [This Protocol may be amended by [a committee of LIBA]. Any amendments to the Protocol will be notified to Adhering Parties by means of the Administrator's website and will become effective upon the publication of the amended version of the Protocol on the Administrator's website.]

10. GOVERNING LAW

10.1 This Protocol and any Adherence Confirmation and Withdrawal Confirmation (together ***the Protocol Documents***) will be governed by and construed in accordance with English law.

10.2 This Protocol and any non-contractual obligations arising out of or in relation to it shall be governed by and construed in accordance with English law. The English courts will have exclusive jurisdiction in relation to all disputes arising out of or in connection with this Protocol (including claims for set-off and counterclaims), including, without limitation, disputes arising out of or in connection with: (i) the creation, validity, effect, interpretation, performance or non-performance of, or the legal relationships established by, this Protocol; and (ii) any non-contractual obligations arising out of or in connection with this Protocol. For such purposes each Adhering Party irrevocably submits to the jurisdiction of the English courts and waives any objection to the exercise of such jurisdiction.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS

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