FINANCIAL MARKETS LAW COMMITTEE

Addressing Legal Issues in Cleared Derivatives

Keynote address at a FIA legal event, London

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23 November 2016

Slide 1 – Addressing Legal Issues in Cleared Derivatives

Hello. Thank you to Simon [Puleston-Jones] and to the FIA for inviting me here today.

I feel privileged to be introducing this conference, which will provide a platform for sharing so many experienced perspectives on an important set of issues, including supervision, prudential regulation, default management , documentation issues and the impact of MiFID II.

What we have today is the opportunity, just four weeks ahead of the holidays, to look back on 2016 as a year of very significant change for derivatives clearing law and regulation.

Significant it may have been, but the changes introduced this year are merely additions to a seven year history of regulatory reform accompanied by dramatic shifts in derivatives markets practice. The industry has coped well so far and I am optimistic that it will continue to do so in future.

Who knows? Maybe next year even the formidable MiFID II requirements will be integrated seamlessly and ahead of schedule.

I did hear someone say a couple of weeks ago that MiFID II implementation would be much easier than we all thought. (Then again, he also said that people would soon start talking about Nigel Farage as the next UK Ambassador to Washington… so he can't be relied upon, can he?)

Slide 2 – November 2016: BIS identifies IRD positions with CCPs for the first time

So, when we refer to significant changes what are we really talking about?

In its bi-annual release of OTC derivative statistics and related commentary, the Bank for International Settlements (BIS) observed that the share of interest rate derivatives with financial institutions other than dealers (a category dominated by CCPs) **climbed from 61% of notional amounts outstanding at end-June 2010 to 75% at end-June 2013 and 86% at end-June 2016**. That's a significant shift.

But the proportion of outstanding credit default swaps (CDS) cleared through CCPs has increased even more dramatically since data were first reported in 2010, **from 10% at end-June 2010 to 23% at end-June 2013 and 37% at end-June 2016.**

The November statistical release by BIS gives us, for the first time in history, official and accurate confirmation of how large the market in interest rate derivatives has become because BIS has separately identified IRD positions with CCPs for the first time.

75% of outstanding contracts in OTC IRD are cleared. That's 62 % of a total underlying interest of $544 trillion.

These are impressively big numbers. (Or perhaps, in deference to the New World Order, I should have said: "These are impressive numbers… *bigly*".)

Slide 3 – Even Small Legal Issues Can Have a Big Impact

In a market this size which is, by definition, standardised, even small legal issues can have a big impact.

Which is why the Financial Markets Law Committee, of which I am the Chief Executive, has engaged early and often with regulatory reforms. I have listed some, but by no means all, of the FMLC's publications on this slide.

In September 2011 we offered an analysis of the then Proposal for a Regulation on OTC Derivatives [now the European Markets Infrastructure Regulation, "EMIR"], raising concerns about issues as diverse as front loading, segregation of client accounts, porting and CCP insolvency.

This was followed by publications dealing with proposed amendments to CASS rules in the FCA Handbook, proposals to submit NDFs to the mandatory clearing obligation, the need for greater coordination among national derivatives regulators, the non-discriminatory access provisions under MiFID II, the recognition and supervision of CCPs, proposals by ESMA to introduce gross margining and shorter liquidation periods, indirect clearing and, as I shall shortly explain, the finality provisions of Part VII of the Companies Act 1989.

But before I turn to that project, I hope you will allow me a short digression so that I can explain who we are and what we do.

Slide 4 – The Financial Markets Law Committee: Remit

On this slide, you will see a short description of the FMLC.

Our objective is both to educate with respect to financial markets law and work towards its better administration by addressing issues of legal uncertainty.

"What is legal uncertainty?" you may thinking; "what exactly does that mean in practice?" To say that the FMLC "addresses issues of legal uncertainty" is not a particularly accessible or punchy concept, I will readily admit.

But in my view, legal uncertainty is just another name for legal risk: the risk of increased litigation over legal rights that are poorly defined, the risk of market disruption because legislation has unintended consequences, or the risk that market standard contracts turn out to be unenforceable. These are broadly the sorts of issues the FMLC has been established to tackle.

Slide 5 – The Financial Markets Law Committee: Structure

The next slide allows me briefly to explain that the FMLC is incorporated as a company and registered as a charity. Historically, it was established by the Bank of England, but it became fully independent in 2013.

When I say rather grandly that I am the CEO of the company , what this actually means day-to-day is that I run a small Secretariat of about 14 staff working full- and part-time on legal analysis, related events management and administration. Our salaries are drawn from donations and a list of Patrons can be found on the FMLC website.

Slide 6 – Other FMLC Research Projects in 2016

Clearing is by no means the only market activity with which the FMLC engages. In fact, our remit requires us to span the entire width of the financial markets. On this slide, you can see a selection of the topics on which we have issued, or will issue, papers this year.

The fact that these publications were not listed on the earlier slide should not be taken to signify that they do not address issues relevant to cleared derivatives. Not only should it be evident that work on Brexit and, to a lesser extent, financial benchmarks is likely to be of relevance here, but one of the most contentious issues addressed by the FMLC in the field of bank resolution is the question of the extent to which regulation requires firms to insert bail-in recognition language in their contracts with foreign CCPs.

Slide 7 – "Caulking the Ship": Weather-proofing Part VII CA 1989

With that short digression, then, I would like to return to the theme of the conference and introduce the FMLC's most recent publication on the legal framework for clearing. In doing so, I should acknowledge the efforts of a working group we established for this project and, in particular, the contribution of the Chair, Barney Reynolds. (The names of the other members can be found at the front of the paper as it is published on our website.)

I've called this little presentation "Caulking the ship" because it is all about making the legal regime for clearing fully waterproof as the markets in Europe and the UK, in particular, set sail on the stormy seas of change.

Slide 8 – The U.K. Legal Regime for Infrastructure: Part VII Companies Act 1989

Part VII of the Companies Act 1989 is the cornerstone of the U.K. legal framework for protecting financial markets infrastructure from legal risk.

There are certainly other vital measures including, for example, the Settlement Finality Regulations and the Uncertificated Securities Regulations but Part VII is the bedrock without which the finality and irrevocability of many of our trade and post-trade processes would be imperilled.

Part VII is designed to safeguard infrastructure from the impact of a participant's insolvency, winding up or default. It guarantees the overriding effectiveness or enforcement of certain security interests in connection with transactions and protects certain rights and remedies over margin held with a CCP.

One of the essential provisions at the heart of this framework is section 159, which allows the default management processes of an exchange or clearing house to take priority over insolvency procedures. Subsection (1) establishes the primacy of default management processes over insolvency law and subsection (2) provides that the powers of an office-holder, such as a liquidator or administrator, shall not be exercised in such a way as to prevent or interfere with actions taken under the default rules of an exchange or clearing house and the transfer of market contracts in accordance with those rules.

Slide 9 – Part VII Companies Act 1989 (prior to changes introduced by SI 2013/1908

Here is the index to Part VII. It is, alas, slightly out of date because the legislation.gov.uk version, which is the only one that would fit on a single slide(!) has not yet been updated to take account of secondary legislation implementing EMIR.

I have highlighted key provisions on the slide.

In yellow, I have highlighted certain definitions that have been drafted in such a way that their scope may be either too narrow or too vague properly to accommodate the realities of the clearing environment.

In red, I have highlighted section 159—the provision to which I have just alluded, which provides that the default management processes of a clearing house or exchange are to take priority over insolvency procedures.

Slide 10 – *Re MF Global U.K. Ltd:* The Potential Impact of Proprietary Claims

However, not every claim with the potential to jeopardise the smooth and efficient operation of a CCP is a claim in insolvency law. A proprietary claim (i.e. in property law) can be just as potentially disruptive.

Re MF Global UK Ltd [2012] EWHC 3415 (Ch), is an interesting example of a property law claim pursued in an insolvency context. In that case, the bankruptcy trustee of MF Global Inc. (which I'll call "Inc") sought to pursue a proprietary claim against the administrators of MF Global UK Limited ("MFG UK") in respect of collateral consisting of US Treasury Bills which had been transferred by Inc to MFG UK in connection with the provision of clearing services by MFG UK. The claim resulted in proceedings to which three UK CCPs were joined.

In the event, the parties reached an out-of-court settlement and the proceedings were brought to a close without a trial of the issues. But if Inc's claim had succeeded the CCPs would have been deprived of collateral worth about US$300 million with which they expected to meet the liabilities to them of MFG UK. Even had Inc's claim been defeated at trial, as seems most likely, the claim could have prevented the CCPs from resolving MFG UK's positions quickly and efficiently. Ultimately, it could have greatly exacerbated the systemic impact of the default.

Slide 11 – Recharacterisation Risk: The Invisible Threat

In that case, the bankruptcy trustee of Inc argued that it had beneficial title to assets in MFG UK's proprietary or "house" account with the CCP. It was, in essence, a recharacterisation claim. (As you know, recharacterisation is when the court declares that, although the parties have adopted a particular legal form for their transaction, their legal relationship is a different one in substance.) Inc was saying that a title transfer financial collateral arrangement should be recharacterised as a security financial collateral arrangement.

Inc argued:

- That a title transfer financial collateral arrangement was not compatible with its regulatory obligations in the United States;
- Both parties had recognised this fact; and
- MFG UK was therefore "estopped" from contending that it had acquired title to the collateral assets from Inc.

Many, of you are lawyers, so you will already know that claims of this sort are expected to have a relatively low chance of success under English law. Recharacterisation is, however, not the only context in which

proprietary claims can arise. They can arise as a result of the misallocation of collateral, "fat finger" errors, shortfalls and failures of due diligence to uncover third party encumbrances.

Slide 12 – Law and Practice: Lost in Translation?

Part VII of the Companies Act 1989 has been extensively amended to implement EMIR and secondary E.U. legislation but the FMLC argues that the framework could be more fully "weather-proofed" against proprietary claims by adjusting the scope of one or two core provisions.

In addition, a recent paper argues that some aspects of clearing practices are not fully accounted for in key definitions relating to market contracts and margin provision, including practices such as:

1. the option of a clearing member to transfer a defaulting client's positions to its own proprietary or "house" account;
2. CCP rules which can temporarily suspend a client's termination against a defaulting clearing member in order to facilitate the "porting" of client accounts;
3. the manner in which an unhedged contract between a clearing member and a CCP (i.e. a "clearing member client contract") may persist after the termination of the client trade; and
4. the design of market standard documentation, which permits a clearing member to account for its losses or gains from a clearing member client contract in closing out a related client trade.

Any failure in the legislation to accommodate existing structures and practices of this kind could ultimately exacerbate the risk of proprietary claims.

And as a footnote to this slide, I might add that, at a time of significant political uncertainty and an uncertain future for the industry, making sure the UK framework for clearing is as robust as possible would be a useful exercise.

Slide 13 – Happily, There's a Solution

Happily, then, I am able to conclude this section on a positive note and announce that there is a relatively straightforward solution. The need to make changes to primary legislation to implement MiFID II offers a tailor-made opportunity to revisit certain definitions in the legislation to check that they fully accommodate market practice and extend the umbrella of protection to all CCP default management processes.

The sections which could usefully be revisited include the ones on this slide:

- 155 (Market contracts)
- 177 (Application of margin not affected by certain other interests)
- 188 (Meaning of "default rules" and related expressions)
- 189A (Meaning of "transfer")
- 190 (Minor definitions)

One thing I would wish to emphasise, however, before I leave this section is that the risks of a proprietary claim disrupting the system are small. In the case of a recharacterisation claim, the chances of success are remote. In the case of a meritorious proprietary claim based on error or misallocation, the claim is likely to be resolved away from the courts, in which case any disruption will be temporary. CCP stress tests are exactly designed to guarantee the kind of resilience that is robust to this kind of temporary disruption.

Nevertheless, I am sure you would agree that we should, as a matter of principle, close any seam or gap that we spot to ensure the fullest protection for the integrity and smooth operation of the system as a whole.

Slide 14 – Change Timeline and Closing Remarks

The seaworthiness of the clearing vessel is all the more important when the markets are being tossed on the stormy waters of change.

And the derivatives markets are certainly no stranger to change.

Since the upheaval of the financial crisis and the Pittsburgh Commitments in 2009, they have witnessed the introduction of Dodd-Frank in the U.S. and of EMIR in the E.U. The role of central clearing has grown massively. For example, less than 10% of credit derivatives were cleared in 2010, this year 37% were – which is very nearly a fourfold increase. And, as we have seen, the total percentage of IRD cleared is even higher—nearly twice that of credit derivatives.

The changes are not all in the past, however. This year we have seen the introduction of the clearing mandate in markets, which are once again facing considerable upheaval against a backdrop of increasing political and economic uncertainty.

Refusing to be distracted, the markets have nevertheless got to grips with, and responded to, the FSB's discussion note on the Essential Aspects of CCP Resolution Planning, and the CPMI-IOSCO consultative report on Resilience and Recovery of CCPs. Legislative proposals in this space are expected soon.

In the New Year, we will be counting down one year until MiFID II comes into force. Its effects—particularly the drive towards execution on electronic platforms—are likely to be as significant as EMIR, if not more so.

With so much change afoot the challenges and the risks of legal uncertainty will be considerable.

Slide 15 – The End

The FMLC stands ready to address these risks pro-actively. I know you do too. When I look at the agenda for this conference I am greatly heartened by the breadth and depth of expertise which is available to help us navigate through the storm.

If the FIA can gather together so many prominent experts to tackle such a wide variety of issues on just one day, there is no limit to what we may be able to accomplish in 2017.

Who knows? We may be able not only to implement MiFID II ahead of schedule but even leave ourselves enough time to attend the investiture of Ambassador Farage.