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Update on EU and US Regulation and Litigation of OTC Derivatives

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Outline

- Key issues in relation to regulation of OTC derivatives
- Summary of EU draft Regulation re regulation of OTC Derivatives
- Relevant provisions of Dodd-Frank Act in the US
- Industry reaction and challenges
- Update on relevant derivatives litigation

Overview

- Following the financial crisis, the regulation of OTC derivatives has been in sharp focus
  - initial impetus was in relation to CDS
  - the OTC market generally now faces much greater regulation
- There have been recent detailed regulatory proposals in the US and the EU and other jurisdictions (e.g. Japan)
- FSA in the UK has also published papers on reforming the OTC derivatives market

Overview (cont.)

- Regulatory proposals are focussed on four key areas:
  - reducing counterparty risk including strengthening clearing requirements
  - reducing operational risk including greater standardisation and electronic processing
  - increasing transparency including through trade repositories
  - improving market integrity (including, in the EU, extending the Market Abuse Directive to OTC derivatives)
- 22 September 2009: leaders of G-20 agreed that all standardised OTC derivatives should be traded on exchanges or electronic trading platforms and cleared through CCPs by the end of 2012

Key Issues to Consider in Regulation of OTC Derivatives and Counterparty Risk

- Increased Standardisation
  - facilitates more central clearing
  - greater market efficiency
  - easier to manage disputes and uncertainties
  - more difficult to tailor contracts to meet particular needs
  - not appropriate for highly structured transactions
- Increased transparency
  - greater market certainty
  - easier for regulators to identify areas of potential systemic risk
  - how much disclosure and how much detail?

Key Issues to Consider in Regulation of OTC Derivatives and Counterparty Risk (cont.)

- Requiring trades to be cleared through CCPs:
  - aimed at reducing counterparty risk
  - will however require close regulation of CCPs
  - CCPs will be systemically important and ‘too big to fail’
  - importance of standardised international rules on regulation and capitalisation of CCPs
  - not all OTC contracts will be suitable for CDS clearing
  - concerns of increased cost
  - ability to have interoperability between different CCPs
  - will assist in obtaining greater transparency
  - quality of assets provided as collateral and creation of ‘wrong way’ risk

Credit Default Swaps – Move to Standardisation

- Big bang protocol – March 2009
  - 60 day look back coverage period for Credit Events
  - establishment of Determination Committees to determine the occurrence of Credit Events and Succession Events
  - auction process to determine final price
- Small bang protocol – July 2009
  - allows for incorporation of auction settlement terms following a Restructuring Event
- Standardisation of certain market terms, e.g. spreads

CCPs for Credit Default Swaps

- CDS were perceived as being a significant contributing factor to the financial crisis
- In February 2009 nine major CDS dealers in Europe agreed in principle to use a European CCP to clear their standard CDS contracts
- In the US, the establishment of central counterparty clearing for CDS was a key element of proposals by the President’s Working Group in November 2008

Central Counterparty Clearing

- CCP will act as intermediary in transactions
- Credit risk of CCP is substituted for credit risk of buyer / seller
- Clearing members will be required to provide initial (fixed) margin and variation (top-up) margin for each cleared contract
- Clearing members will be required to contribute to a default fund

The Move Towards CCPs for OTC Derivatives

- A significant number of OTC Derivatives were cleared prior to the financial crisis
- Those that were not cleared were often collateralised
- Certain sectors of the market, e.g. CDS were however often not cleared
- Lehmans failure and AIG bailout highlighted concerns of systemic implications of counterparty failure

IOSCO / CPSS Recommendations for Central Counterparties to OTC Derivatives

- On 12 May 2010 IOSCO and the CPSS issued a consultative report containing proposed guidance for CCPs clearing OTC Derivatives
- Report sets out guidance on the application of the 2004 IOSCO / CPSS Recommendations for Central Counterparties (RCCP) to CCPs clearing OTC derivatives
- Recommendations include:
  - legal risk: CCPs should establish a well-founded, transparent and enforceable legal framework for all jurisdictions where they operate
  - participation requirements: participants should be required to have sufficient financial resources and a robust operational capacity to meet their obligations and the CCP should have procedures in place to monitor this obligation

IOSCO / CPSS Recommendations for Central Counterparties to OTC Derivatives (cont.)

- Recommendations (cont.):
  - measurement and management of credit exposures: CCPs should measure credit exposure of participants on an ongoing basis and at least once a day
  - margin requirements: margin should be sufficient to cover potential exposure in normal market conditions. Relevant models and parameters should be risk based and reviewed regularly
  - financial resources: CCPs should maintain sufficient financial resources to withstand, at the very least, default by the participant to which they have the largest exposure in extreme but plausible market conditions
  - operational risk: CCPs should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures
  - other recommendations relate to default procedures, governance, efficiency, transparency and regulation and oversight

EU Proposed Regulation of OTC Derivatives - History

- EU Commission published a communication in July 2009 – “Ensuring efficient, safe and sound derivatives markets”.
- In June 2010 the EU Commission published a public consultation prior to it finalising its legislative proposals
- Draft Regulation on OTC derivatives, central counterparties and trade repositories was published on 15 September 2010
- Draft Regulation is intended to be aligned with Dodd-Frank legislation on key issues

EU Proposed Regulation of OTC Derivatives - Overview

- An obligation on all financial counterparties to clear all eligible derivative contracts with CCPs
- An obligation on participants to report all OTC derivative contracts to trade repositories
- Obligations in respect of reporting, reconciliation, collateralisation and holding of capital in relation to non-clearing eligible OTC derivatives
- Rules relating to the authorisation and supervision of CCPs
- Organisational, conduct of business and prudential requirements for CCPs
- Rules on interoperability of CCPs
- Provisions for the registration and surveillance of trade repositories

EU Proposed Regulation of OTC Derivatives – The Clearing Obligation

- All financial counterparties must clear all eligible derivative contracts through a CCP
- There is a dual process for determining whether a contract is eligible for clearing:
  - a bottom-up approach: where a CCP is granted permission from its competent authority to clear an OTC contract, the authority must inform ESMA. ESMA must decide within 6 months whether a clearing obligation should apply
  - a top-down approach: ESMA and the ESRB will determine which contracts not as yet being cleared by a CCP should be eligible for clearing
- CCPs must accept the clearing of eligible contracts it is authorised to clear on a non-discriminatory basis regardless of the execution venue

EU Proposed Regulation of OTC Derivatives – Non Financial Counterparties

- Non-financial counterparties are exempt from the clearing obligation unless its position in OTC derivatives exceeds a "clearing threshold"
  - it is not clear where the clearing threshold will be set
  - if the counterparty's position exceed the clearing threshold, it will be subject to a clearing obligation for all its eligible derivative contracts
  - in calculating the counterparty's positions it can disregard any derivative that is objectively measureable as directly linked to the commercial activities of the counterparty

EU Proposed Regulation of OTC Derivatives – Non-Clearing Eligible Derivatives

- Counterparties in relation to OTC derivatives not considered eligible for central clearing will be required to use or implement the following:
  - electronic means of ensuring timely confirmation of the contract terms
  - robust, resilient and auditable processes to reconcile portfolios, manage risks and monitor the value of outstanding contracts
  - timely, accurate and appropriately segregated exchange of collateral
  - appropriate and proportionate holding of (additional) capital
- These obligations will apply to financial counterparties and non-financial counterparties above the clearing threshold
- ESMA will publish draft regulatory technical standards in relation to non-eligible OTC derivatives trades which should be in force by 30 June 2012

EU Proposed Regulation of OTC Derivatives – Reporting Obligation

- Financial counterparties will be under an obligation to report to a trade repository the details of any OTC derivative contract they have entered into:
  - obligation also applies to novation, termination or modification of existing contracts
  - must report no later than one day after the relevant event
- Non-financial counterparties will also be under such an obligation if their positions exceed an information threshold
- The EU Commission (in accordance with technical standards to be developed by ESMA) will determine the details, type, format and frequency of reports for different types of contract but as a minimum they must contain:
  - the parties to the contract (and any other beneficiaries to the contract)
  - the main characteristics of the contract including type, underlying, maturity and notional value

EU Proposed Regulation of OTC Derivatives – Authorisation and Supervision of CCPs

- CCPs established in the EU must apply for authorisation by a competent authority
- Certain minimum requirements must be complied with:
  - minimum capital of at least €5 million
  - sufficient capital and retained earnings to protect against operational and residual risks
  - it must have access to adequate liquidity through the central bank and/or a creditworthy and reliable commercial bank
- National competent authorities will be responsible for authorisation and supervision of CCPs in their jurisdiction
- ESMA will however also have an important role including:
  - ensuring common and objective application of the Regulation
  - developing draft technical standards
  - recognising and supervising CCPs from “equivalent” third countries

EU Proposed Regulation of OTC Derivatives – Other Requirements for CCPs

- Organisational requirements:
  - independent risk committee
  - adequate internal systems and conflicts of interest management
  - notification by parties acquiring or selling holdings above certain thresholds in the CCP
- Conduct of business requirements:
  - overriding duty to act fairly and professionally in best interests of its members and to effect sound risk management
  - establish appropriate criteria for its clearing members
  - disclosure of fees and risks associated with the services provided

EU Proposed Regulation of OTC Derivatives – Margin and Collateral Requirements

- CCPs are required to require each clearing member to distinguish and segregate the assets and positions of each of the member's clients from the member's own assets and positions
- A CCP must also:
  - keep records and accounts which enable it any time and without delay to identify and segregate the assets and positions of a clearing member from those of the CCP and any other clearing member
  - depending on the level of segregation chosen by a client, ensure it is able to transfer on request at a pre-defined trigger event without the consent of the clearing member and, within a pre-defined transfer period, its assets and positions to another clearing member, subject to the other clearing member having previously entered into a contractual relationship for that purpose
- Clients may treat their exposures as exposures to a CCP giving an exposure of zero provided it is not exposed to the default of the clearing member through which it has access to the CCP

EU Proposed Regulation of OTC Derivatives – Margin and Collateral Requirements (cont.)

- Other requirements imposed on CCPs include:
  - measuring liquidity and credit exposures to clearing members and any CCPs with which it has concluded an interoperability arrangement on a near to real time basis
  - setting margin requirements to capture the risk characteristics of the products cleared, the interval between margin collections and market liquidity
  - calling and collecting margins to limit its credit exposures to clearing members at a level sufficient to cover losses arising from at least 99% of the exposure movements over an appropriate time horizon
  - segregating the margins provided by each clearing member and other CCPs with which it has an interoperability arrangement
  - maintaining a mutualised default fund to which clearing members must contribute
  - having default procedures in place to deal with a clearing member's failure to comply with the participation agreement
  - accepting only highly liquid collateral with minimal credit and market risk
  - only investing its resources in highly liquid financial instruments with minimal market and credit risk and acceptable concentration limits

EU Proposed Regulation of OTC Derivatives - Interoperability

- Interoperability is defined in the Regulations as an "arrangement between two or more CCPs that involves a cross-system execution of transactions"
- Regulatory approval will be required before a CCP may enter into an interoperability agreement
- CCPs entering into an interoperability arrangement must put in place adequate risk management systems to effectively identify, monitor and manage the risks including:
  - additional risks arising from the interoperability arrangements including credit and default risks
  - interdependencies and correlations that may affect credit and liquidity risks
- The scope of the interoperability arrangements should be restricted to cash securities (transferable securities and money market instruments)

EU Proposed Regulation of OTC Derivatives – Trade Repositories

- ESMA will be empowered to authorise trade repositories in the EU
- Registration of a trade repository will be effective through the EU
- ESMA can recognise trade repositories established in a non-EU country provided:
  - it is authorised and subject to effective surveillance in the third country
  - the EU Commission determines the legal and supervisory arrangements of the third country is equivalent to those of the EU
  - ESMA has established co-operation arrangements with the third country's competent authorities
  - the EU has entered into an international agreement with the third country on mutual access to and exchange of data contained in trade repositories
- The Regulation will impose ongoing standards for trade repositories including governance, compliance, operational systems and confidentiality arrangements

Dodd-Frank Act - Introduction

- Dodd-Frank Wall Street Reform and Consumer Protection Act
- Title VII governs the regulation of derivatives markets and their participants
  - creates parallel regulatory regimes for the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC)
  - the two regimes are not identical but have many common elements
- Key distinction is between "swaps" and "security-based swaps"
- For convenience, in the following slides on Dodd-Frank, "swaps" refers to both swaps and security-based swaps and "swap dealers" refers to both swap dealers and security-based swap dealers unless otherwise specified. References to "major swap participants" or "MSPs" includes references to both major swap participants and major security-based swap participants

Dodd-Frank Act – Definition of Swaps

- Broad definition that includes (among other things):
  - options, with certain exclusions
  - any agreement, contract, or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence
  - swaps - agreement involving 1 or more payments based on the level of 1 or more underlyings, that transfers the financial risk associated with a future change in such value or level without also conveying an ownership interest in an asset or liability that incorporates the financial risk so transferred
  - security-based swap agreements i.e. any swap referencing a security or group or index of securities
  - combination of the above

Dodd-Frank Act – Definition of Swaps (cont.)

- But excludes (among other things):
  - sales of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is *intended to be physically settled*
  - any option on any security or group or index of securities that is subject to the 33/34 Acts
  - any forward on one or more securities that is subject to the 33/34 Acts
  - any note, bond, or evidence of indebtedness that is a security
  - “identified banking products,” including CDs
  - “security-based swaps”, other than mixed swaps

Dodd-Frank Act - Security-based Swaps

- Any agreement, contract, or transaction that is a swap and is based on:
  - narrow-based security index (generally, 9 or fewer component securities)
  - single security or loan
  - CDS relating to:
    - single issuer of a security
    - issuers of securities in a narrow-based security index

Dodd-Frank Act - Swap Dealers

- A Swap Dealer is any person who:
  - holds itself out as a dealer in swaps
  - makes a market in swaps
  - regularly enters into swaps with counterparties as an ordinary course of business for its own account or
  - engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps
- Can be a swap dealer for purposes of some swaps but not others
- Requires CFTC / SEC to prescribe *de minimis* exception
- *Only for swap dealers (not security-based swap dealers)*
  - excludes an insured depository institution to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer

Dodd-Frank Act - Major Swap Participants

- Any person who is not a swap dealer and meets any of the following:
  - maintains a ***substantial position*** (to be defined by rule) in swaps for any of the major swap categories as determined by the applicable regulator, excluding:
    - positions held for hedging or mitigating commercial risk
    - positions maintained by any pension plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan
  - its outstanding swaps create ***substantial counterparty exposure*** that could have serious adverse effects on the financial stability of the US banking system or financial markets
  - is a financial entity that (i) is highly leveraged relative to the amount of capital that it holds, (ii) is not subject to a Federal banking agency's capital requirements, and (iii) maintains a substantial position in outstanding swaps in any major category

- *Only for MSPs (not major security-based swap participants)*
  - excludes financing affiliates of manufacturers using derivatives to hedge commercial risks relating to interest rate and fx exposures
  - 90% or more of the financing must be for facilitating purchase on lease of products
  - 90% of more of those products must be manufactured by the parent company or its subsidiary

Dodd-Frank Act – Clearing and Mandatory Exchange Execution

- A swap must be cleared if:
  - ➢applicable regulator determines that it is required to be cleared; AND
  - ➢clearing organisation accepts it for clearing
- Determination process can be for any single swap, or any group, category, type, or class of swaps
  - ➢CFTC / SEC initiated review (conducted "on an ongoing basis")
    - must provide 30-day public comment period
  - ➢clearing organisation must submit to applicable regulator each swap (or group, category, type, or class of swaps) that it plans to accept for clearing
    - applicable regulator must make its determination within 90 days after submission, unless clearing organisation agrees to an extension
    - after determination, may stay the clearing requirement to complete review of swap terms and clearing arrangement
- If a swap is subject to the clearing requirement, it must be executed on an exchange or swap execution facility
  - ➢exception if no exchange or swap execution facility makes the swap available for trading

Dodd-Frank Act - Commercial Hedging Exception

- Mandatory clearing requirement does not apply if one of the parties
  - is not a "financial entity";
  - is using swaps to hedge or mitigate commercial risk; AND
  - notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps
- Application of the clearing exception is solely at the discretion of the commercial hedging entity
- Financial entity:
  - Includes swap dealers, MSPs, commodity pools, certain private funds, pension plans
  - persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature
  - CFTC / SEC must consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions with total assets of $10B or less
  - excludes financing affiliates of manufacturers (only for swaps)

Dodd-Frank Act - Treatment of Existing Swaps

- Clearing requirements will not apply if reported to a swap data repository or, if none, the applicable regulator in a timely manner:
  - if entered into *before* enactment of the Act, must report within 180 days after effective date of Title VII, which is the later of 360 days after enactment or, to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule implementing the provision
  - if entered into *on or after* enactment of the Act but *before* the effective date, must report by the later of:
    - 90 days after the effective date
    - such other time after entering into the swap as the applicable regulator may prescribe

Dodd-Frank Act - Margin Requirements

- Swap dealers and MSPs will be subject to initial and variation margin requirements for non-cleared swaps
  - banking regulators to adopt rules for bank swap dealers and bank MSPs
  - CFTC or SEC to adopt rules for non-bank swap dealers and non-bank MSPs
- To "offset the greater risk" to swap dealers, MSPs and the financial system for non-cleared swaps, the margin requirements shall:
  - help ensure the safety and soundness of the swap dealer and MSP; and
  - be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or MSP
- Act permits use of non cash collateral to the extent consistent with (i) preserving financial integrity of markets trading swaps and (ii) preserving stability of US financial system
- Question as to whether margin requirements apply retroactively not resolved
- *Absence of Exception to Margin Requirements:*
  - Senate bill provided an exception to the margin requirements if one of the counterparties is a commercial end user
  - Act does not appear to have this exception, though it could be implemented via rulemaking

Dodd-Frank Act - Segregation of Margin

- For non-cleared swaps, if requested by the counterparty, a swap dealer or MSP must hold its counterparty's initial margin in a segregated account at an independent third-party custodian:
  - swap dealers and MSPs must notify counterparty at inception of trade of right to require segregation of initial collateral
  - if the counterparty does not elect to segregate, the swap dealer / MSP must report quarterly to its counterparty that its back office procedures relating to margin and collateral requirements are in compliance with the agreement of the parties

Dodd-Frank Act - Capital Requirements

- Swap dealers and MSPs will be subject to minimum capital requirements:
  - banking regulators to adopt rules for bank swap dealers and bank MSPs
  - CFTC or SEC to adopt rules for non-bank swap dealers and non-bank MSPs
  - in setting capital requirements for swap dealers and MSPs for a single type, class, or category of swaps, must consider risks associated with other types of swaps or classes of swaps or categories of swaps engaged in and the other activities conducted by that entity

- To "offset the greater risk" to swap dealers, MSPs and the financial system for non-cleared swaps, the capital requirements shall:
  - help ensure the safety and soundness of the swap dealer and MSP and
  - be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or MSP

Dodd-Frank Act - Business Conduct Standards

- Swap dealers and MSPs will be subject to new business conduct standards to be adopted by the applicable regulators
- Regulators have broad authority to set new business conduct standards
- Among other things, the new standards and requirements shall require swap dealers and MSPs to disclose information to non-swap dealers and non-MSPs including information relating to material risks and characteristics of the swaps, relevant conflicts of interest and, upon request, the daily mtm (to be produced without request for non-cleared swaps)
- Swap dealer and MSP must communicate with counterparty in a fair and balanced manner based on principles of fair dealing and good faith

Dodd-Frank Act - Reporting

- All swaps must be reported to a registered swap data repository or, if there is no repository that would accept it, to the CFTC / SEC within timeframes to be laid down by CFTC / SEC
- Real-time public reporting is required for:
  - swaps required to be cleared (even if not cleared due to the end-user exemption)
  - swaps voluntarily cleared
  - swaps not cleared that are reported to a swap data repository or the CFTC / SEC (but public reporting in this case does not include disclosure of the "business transactions and market positions of any persons")

Comparison Between Proposed EU Regulation and Dodd-Frank Act

- Scope of both EU Regulation and Dodd-Frank is similar but there are differences – in US, Secretary of State may decide to exempt FX swaps and forwards
- Non-financial entities:
  - under Dodd-Frank if one party is a non-financial entity it can opt out of the clearing obligation if the derivative is solely used for hedging or mitigating commercial risks
  - EU based non-financial entities are only obliged to clear if certain thresholds are met. They can also disregard any derivative that is objectively measurable as directly linked to the commercial activities of the counterparty
  - Under EU proposals non-financial entities are only required to report OTC derivatives if a reporting threshold is exceeded. Under Dodd-Frank, non-financials must report all swap transactions
- Conduct of business rules:
  - under Dodd-Frank the CFTC / SEC will establish new business conduct rules
  - in the EU some issues such as pre and post trade reporting of derivatives will be dealt with under the forthcoming MiFiD review

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Clearing eligibility process is similar in EU and US
  - both require impetus from clearing entities and from regulators
  - regulators' decisions to be based on similar criteria – some additional criteria to be considered by US regulators (competition and legal certainty in event of clearing system insolvency)
  - Non-discriminatory acceptance for clearing of derivative from an approved class – irrespective of venue of execution
- Risk mitigation – both EU and US expected to adopt minimum capital requirements and margin requirements for non-cleared swaps, but more clearly spelt out in Dodd-Frank

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Regulation of CCPs
  - in EU, more detailed cob, organisational and prudential rules. In US, relevant regulators still to set standards
  - grandfathering of existing clearing systems is provided for in EU and US
  - both provide for recognition of foreign clearing systems based on determination of them being subject to similar supervisory framework
  - both provide for minimum CCP capital requirements, but figures not yet laid down in US
  - ownership – no ownership cap in EU, but ownership structure publicly disclosed and changes in shareholdings require notification to regulator. US regulators may impose shareholding limits
  - segregation and portability of customer positions and margin requirements – largely similar
- Trade repositories
  - both require registration system
  - in EU requirements to recognise foreign repositories subject to similar supervisory regimes. No specific US requirements except provision that Dodd-Frank does not apply outside the US except for activities having a direct US connection
  - similar provisions apply re risk control, disclosure and reporting, governance, confidentiality

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- EU proposed regulation does not include mandatory exchange trading provisions unlike Dodd-Frank
- Dodd-Frank does not contain provisions relating to the interoperability of CCPs
- No equivalent of Volcker rule or swaps push-out rule in the EU Regulation:
  - Volcker rule will limit proprietary trading by banks and certain other financial institutions
  - the swap push-out rule provides that no federal assistance be provided to any swaps entity with respect to any swap or other activity of the swaps entity
- Timing:
  - most provisions of Dodd-Frank including implementing rules to be promulgated by the CFTC, the SEC and other regulators will become effective at the same time – in most cases July 2011
  - EU Regulation intended to come into force in 2012 – technical standards due to be completed by ESMA by end of June 2012

Issues for Cross-border Institutions

- Dodd-Frank will not apply to activities outside the US unless:
  - they have a direct and significant connection with activities in, or effect on, commerce of the U.S. or
  - they contravene such rules or regulations as may be prescribed under the Act necessary or appropriate to prevent the evasion of the relevant provisions of the Act
- Dodd-Frank envisages that swaps may be cleared through foreign clearing houses
- EU draft Regulation:
  - applies to entities with an establishment in the EU
  - envisages CCPs outside the EU subject to specified criteria
- Major cross-border financial institutions are, however, likely to have to consider both sets of rules

Industry Challenges

- Logistical challenges of new regulation:
  - many rules not yet drafted
  - likely to result in significant changes to the way many transactions are transacted and settled
  - impact on hedge funds
- Central counterparties:
  - scope for competition
  - ‘too big to fail’ issue

Industry Challenges (cont.)

- Impact on non-financial institutions
- Impact on industry:
  - overall costs
  - standardisation
  - transparency
  - liquidity

Credit Default Swaps

- Proposed EU regulation on Short Selling and Credit Default Swaps published in September 2010
- Requires disclosure of naked/uncovered CDS position referencing EU sovereign debt
- Position considered naked to the extent it is not hedging a long position in such sovereign debt or a long position in the debt of an issuer with a high correlation to particular EU sovereign debt
- Commission to adopt measures specifying examples of where a CDS is being used for hedging purposes and how to calculate “nakedness” when different group members have long/short positions
- Requirement to notify relevant competent authority when nakedness crosses a certain threshold to be specified by the Commission

Credit Default Swaps (cont.)

- Notification to include details of identity of holder of naked short position (buyer of credit protection), size of position, identity of issuer and date of creation / change of position
- Timing – positions measured as of midday on each trading day and notification required by 3.30pm next trading day (uncertainty as to meaning of trading day)
- Relevant competent authority given power to temporarily prohibit / restrict EU sovereign CDS in “exceptional situations”
- ESMA has monitoring role in relation to such action proposed by a competent authority
- ESMA may itself impose prohibitions / restrictions on EU sovereign CDS in “exceptional situations”
- Note possible prohibition not limited to “naked” CDS

Recent Litigation Developments

- **Rights under Derivative and other Contracts and Insolvency Law in the US and UK. Which prevails? A battle of statute and market practice? A battle of jurisdictions?**

- Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd
- *Priority in insolvency on and the enforceability of flip clauses*

- Marine Trade SA v Pioneer Freight Future Co Ltd
- *What is the effect of an Event of Default on payment obligations?*

- ISDA amicus brief in Swedbank v Lehman Brothers
- *Contractual right to set off and the mutuality requirement under Insolvency law*

Perpetual Trustee - Facts

- A swap agreement was entered into whereby, on the enforcement of security, the swap counterparty would take priority over the noteholders
- This priority was subject to the swap counterparty not triggering an Event of Default under the swap agreement
- If the swap counterparty defaulted, priority would ‘flip’ to the noteholders
- On 15 September 2008 - Event of Default
- The noteholders issued proceedings arguing that the swap counterparty had defaulted and that they now had priority on the enforcement of security

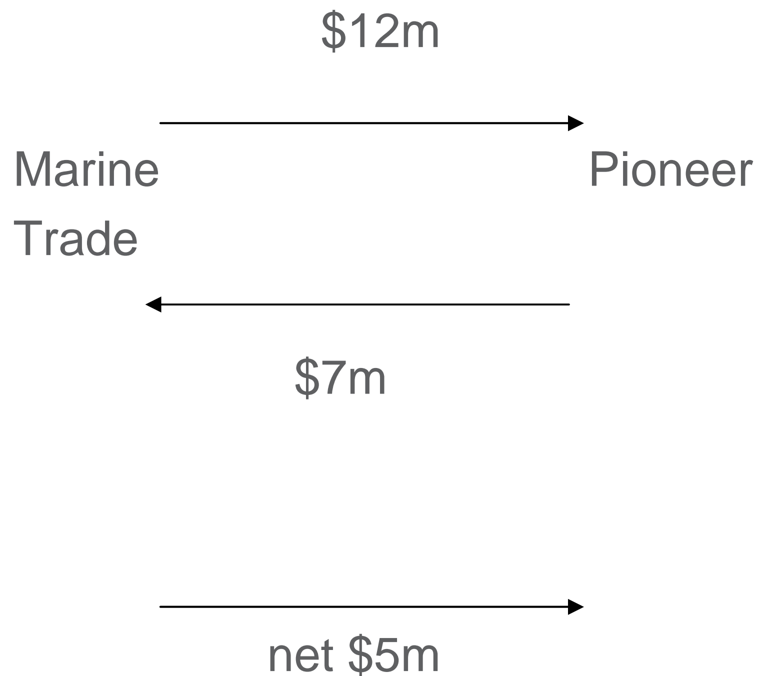
Perpetual Trustee – Key Issues

- English Courts Perspective:
  - The Court of Appeal decided in favour of the noteholders
  - As the relevant Event of Default had occurred on 15 September 2008, which was before the swap counterparty defaulted, the ‘priority flip’ could not be attacked
- US Court Perspective:
  - The US Bankruptcy Court held that the ‘priority flip’ provision was an unenforceable ipso facto clause
- Cross-border conflict
  - This polar opposite view has created some uncertainty as to the enforceability of subordination provisions
  - A number of commentators have suggested that this may cause a number of transactions to migrate from the US
  - Date of appeal

Perpetual Trustee – UK Position

- Despite the cross-border conflict, the UK legal position seems clear:
  - Confirmation of the principle that an insolvency official must take a company's rights as it finds them
  - The mere fact that priority can be reversed following winding up does not contravene the *pari passu* principle

Marine Trade – Key Facts 1



- Settlement payments were due from each party under 14 Freight Forward Agreements
- Payment netting would usually apply and a net payment of $5m was due to Pioneer

Marine Trade – Key Facts 2

- On the settlement date, Marine Trade considered Pioneer insolvent which constituted an Event of Default
- Marine Trade withheld the payment to Pioneer of $12m and maintained their claim for $7m (thereby ignoring the netting which usually occurred)
- They relied on s.2(a)(iii) of the ISDA Master Agreement to claim the $7m while withholding the $12m
- Ultimately, Marine Trade paid the net sum of $5m to Pioneer under protest, but issued proceedings to claim the $12m back

Marine Trade – Key Issues

- The court ruled in favour of Marine Trade, saying that their construction of s.2 of the ISDA Master Agreement was correct
- The court went further and gave its obiter view on the effect of s.2(a)(i) and (iii) of the ISDA Master Agreement, where a party was in default on the settlement date, but subsequently resolved the Event of Default:
  - The sections are a "*"one time" provision for the calculation and assessment"* of whether an amount is payable under s.2 of the ISDA Master Agreement.
- This means that even if an Event of Default is resolved, the payment obligations are not automatically revived
- On the face of it, Marine Trade had secured a significant victory, however, they were not successful in arguing that the $5m they paid to Pioneer under protest was a mistake and were not able to recover it

ISDA Amicus Curiae Brief 1

Swedbank AB v Lehman Brothers Holdings Inc

- Prior to Lehman Brothers Holdings' ("**LBHI**") bankruptcy filing:
  - Swedbank was a party to four ISDA Agreements with several Lehman entities;
  - LBHI served as a guarantor in connection with those agreements;
  - LBHI maintained a deposit account with Swedbank AB ("**Swedbank Account**"); and
  - LBHI was a party to an ISDA Agreement with Swedbank AB, within which there was a provision which granted Swedbank AB a right of set-off upon the occurrence of an Event of Default.

ISDA Amicus Curiae Brief 2

- Following LBHI's bankruptcy filing, Swedbank AB informed LBHI that it intended to set-off the sums owed to Swedbank AB against the LBHI funds contained in the Swedbank Account

- The Swedbank Account contained nearly $12m following post-petition deposits by LBHI

- The debtors argued that Swedbank AB had no right of set-off and filed a motion to compel Swedbank AB to turn over the funds in the Swedbank Account

ISDA Amicus Curiae Brief 3

US Bankruptcy Court Decision

- According to the decision, the requirement that a claim and debt be mutual in order to exercise a right of set-off is *"an axiomatic principle of bankruptcy law"*
- In this case, all parties were agreed that there was no mutuality because LBHI's indebtedness to Swedbank AB arose pre-petition and the funds in the Swedbank Account were deposited post-petition
- Swedbank AB unsuccessfully argued that the safe-harbour provisions of the US Bankruptcy Code implicitly overrode the statutory requirements of mutuality

ISDA Amicus Curiae Brief 4

ISDA's Amicus Brief in the US District Court

- Swedbank AB appealed the decision and ISDA submitted an Amicus Curiae brief to the US District Court, arguing that the safe-harbour provisions should be interpreted literally and that the contractual rights in swap agreements should be protected from all the limitations imposed by the US Bankruptcy Code
- ISDA has submitted that the US Bankruptcy Court's narrow interpretation of the safe harbour provisions threaten to inject a significant level of uncertainty and disruption into the financial markets, which goes against the spirit of the provisions

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