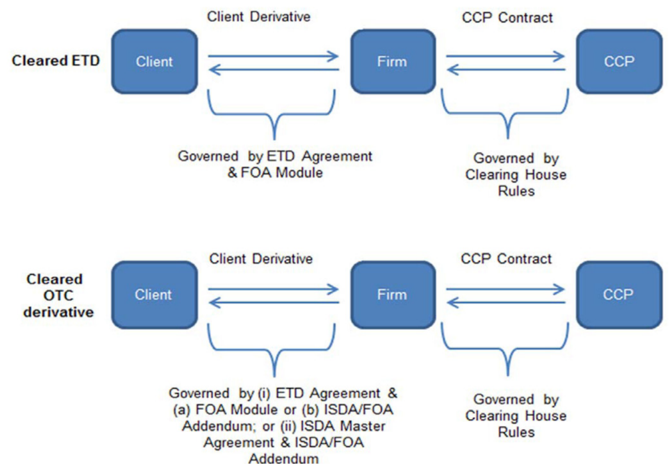
DERIVATIVES CLEARING: WHY HAVE CLIENTS LOST THEIR RIGHT TO CLAIM FOR LOSSES?

The standard documents in use for central clearing of OTC and exchange-traded derivatives in Europe oblige clients to surrender their normal contractual right to claim for compensation should their clearing member default. If following a clearing member default a client's derivatives are terminated by the clearing house acting as central counterparty (the "CCP"), then instead of being able to claim for the cost of being put in the position that the client would have been in had the clearing member not defaulted, the client is obliged to accept a CCP valuation that does not take the client's circumstances into account. This creates a significant risk of unrecoverable losses for clients, a result that is not needed for the proper functioning of the derivatives market and which may add to the inevitable market stress should a major derivatives clearing member default. This situation should be remedied by restoring within the industry standard documents the client's right to claim for its full losses.

BACKGROUND

In response to the requirements imposed by the European Market Infrastructure Regulation[1] ("EMIR") with regard to the trading and clearing of derivatives, Europe-based clearing members and their derivatives clients are re-documenting their relationships. In this they have been assisted by two industry standard English law documents published in 2013, the *FOA Clearing Module*[2] (the "Module") published by FIA (published under the prior name of FIA's European arm, the Futures and Options Association), which deals with clearing exchange-traded derivatives ("ETDs") and OTC derivatives; and the *ISDA/FOA Client Cleared OTC Derivatives Addendum*[3] (the "Addendum") as jointly published by the International Swaps and Derivatives Association and FIA, which covers clearing of OTC derivatives, but not ETDs. The clearing documents were published after a lengthy drafting process involving market participants.

The clearing documents cover the relationship between the clearing member and its client under "principal to principal" clearing relationships where the clearing member acts as an intermediary between two derivatives: a cleared derivative (the "CCP Contract") with a CCP; and a second, economically equivalent, derivative with the clearing member's client (the "Client Derivative"). The clearing documents are supplementary to the existing agreements used for ETD and OTC derivatives. The relationship is shown in the diagram opposite.



Central clearing of standardised derivatives was a commitment contained in the 2009 G-20 Leaders Statement at the Pittsburgh Summit, with the objective of reducing systemic risk in derivatives markets. Central clearing of derivatives creates a number of benefits, notably the possibility that, if a clearing member defaults, its clients can potentially transfer the cleared derivatives and associated collateral held at a CCP to an undefaulted clearing member (a process known as "porting"). If a major financial institution defaults and porting is successful, the significant credit losses that its derivative clients could otherwise incur on termination of derivatives may be avoided. This note focuses only on the consequences if porting fails, which would lead to the CCP having to terminate the derivatives associated with the defaulted clearing member's clients. If this occurs, the clearing documents needlessly create a risk of unrecoverable loss for clients.

THE PROBLEM CAUSED BY CLIENTS NOT HAVING THE RIGHT TO CLAIM FOR THEIR FULL LOSSES

The clearing documents provide that if a clearing member defaults and its clients' cleared derivatives are terminated rather than porting to a new clearing member, when determining the amount that must be paid between the clearing member and a client for the terminated Client Derivative, the same value must be used as that which the CCP imposes on the clearing member for the CCP Contract[4]. This use of the CCP valuation creates a risk of significant unrecoverable losses for clients if the porting process doesn't succeed.

[1] Regulation (EU) 648/2012

[2] The Module is available for subscribers to FIA Europe Documentation Library on www.foa.co.uk, and FIA Europe has confirmed to Macfarlanes that the Module is typically made available to non-subscribers on direct application to the Legal Documentation team at FIA Europe.

[3] The Client Cleared OTC Derivatives Addendum is available on http://www.isda.org/publications/isda-clearedswap.aspx.

[4] The relevant clauses that provide for the use of the CCP termination levels are clause 5.2.2(c) of the Module, and clause 8(b)(ii)(2) of the Addendum.

To give an example of how the concern arises (using Lehman Brothers to stand in for the client's counterparty):

- Suppose a client enters into a single derivative with Lehman Brothers under a standard ISDA master agreement, and the derivative is not centrally cleared. The derivative is acting as a hedge for the client. Lehman Brothers defaults at a time when the derivative has a mark-to-market value close to zero. The derivative terminates. The client replicates the derivative with another dealer as it needs to replace the hedge. The other dealer charges $10 to replicate the derivative. The client is out of pocket $10. The client claims $10 from the Lehman Brothers insolvency using the normal ISDA master agreement closeout mechanism.
- Now suppose that the derivative with Lehman Brothers is cleared through a CCP with Lehman Brothers as clearing member, and Lehman Brothers and its client are using the new clearing documents[5]. Lehman Brothers defaults and the derivative is terminated rather than porting to a new clearing member. As before, the client replicates the derivative with another dealer, and pays the dealer $10 to do so. Separately, the CCP runs an auction among undefaulted clearing members to enter into a derivative with the CCP to replace the terminated CCP Contract equivalent to the Client Derivative[6]. The winning auction bidder requires $25 to enter into the replacement derivative with the CCP, which the CCP must pay. Under the clearing house rules the insolvent Lehman Brothers must pay the CCP $25 for the terminated CCP Contract. Under the clearing documents' terms, the client must now pay Lehman Brothers $25 for the terminated Client Derivative. The client is now out of pocket $35, with no opportunity to recover from the insolvency estate.

[5] Lehman Brothers may be party to a number of derivatives with a client that were originally agreed by the client with a third party executing broker and then cleared by Lehman Brothers such that the client no longer faces the executing broker. This is a common feature of central clearing with CCPs, but also occurs with derivatives that are not centrally cleared - particularly where the party in the position of Lehman Brothers is acting as prime broker, interposing itself as intermediary between the client and the executing broker, and acting as principal counterparty to both. The principles described in this article apply equally whether the executing broker for the derivative was a third party or the party in the position of Lehman Brothers in the examples above.

[6] A default auction among undefaulted clearing members is a common means of dealing with the CCP's exposures under the CCP Contracts of a defaulted clearing member. For example, a default auction is provided for in Chapter 11 of Eurex Clearing AG's *Procedures Manual*, and in LCH Clearnet Limited's *Default Rules*.

The odd result of using the new clearing documents' terms for valuing terminated cleared derivatives is that Lehman Brothers is effectively insulated from the losses that its own default causes. Lehman Brothers has escaped liability for the $10 of losses it caused the client, and can pass on to the client the $25 loss that Lehman Brothers' default caused the CCP. Not only is this result not required by EMIR, it appears to run counter to the G-20 objective of reducing systemic risk in derivatives markets. It is contrary to normal contractual principles for claims for breach of contract and to the ordinary measure of creditor claims under bankruptcy law.

ANSWERING THE ARGUMENTS PUT FORWARD THAT CLIENTS SHOULD NOT HAVE THE RIGHT TO RECOVER LOSSES

Various reasons have been put forward for the valuation approach adopted in the clearing documents. Considering them in an article may appear like attacking straw men, but it is better to address them here rather than leave arguments that are commonly put forward unanswered.

A number of dealers and other commentators argue that a firm clearing derivatives needs greater protections than a party to a bilateral derivative, as a clearing member acts as a service provider intermediary in facilitating access to the CCP. As a service provider they draw an analogy to a broker acting as a "riskless principal" in securities markets, where the intermediary broker acts as principal to trades with a buyer and a seller, and the market price is the same on both principal trades. However, it is not the case that a riskless principal in securities markets is insulated from losses in the way that the clearing documents provide. If an executing broker that was acting as a riskless principal in the OTC securities market were to default in the period between trade date and settlement date of the securities, it would face a claim from the intended buyer of those securities for the difference between settlement price and the price at which the buyer could buy elsewhere; and at the same time the broker would face a claim from the intended seller for the difference between settlement price and the price at which the seller could sell elsewhere. When trading OTC securities, there is no equivalent of the clearing documents' requirement that a defaulting clearing member face the same price on both sides of the cleared derivative.

Some dealers have voiced a concern that being liable for a client's losses acts as an undue disincentive to act as a clearing member. This concern is unjustified, as a service provider should not be incentivised to provide a service by a clause that on insolvency effectively provides for a transfer

of wealth from its derivatives clients to its insolvency estate (the $25 payment in the example above), to subsequently be transferred from the insolvency estate to the service provider's other creditors – and conversely a service provider should not be discouraged from offering a service if its insolvency estate remains liable for the consequences of the service provider's fundamental breach of contract. Using the CCP's valuation on default of a clearing member subtracts value from the relationship between a clearing member and its clients, as it creates risks of unrecoverable loss for clients with no corresponding benefit to the clearing member.

For ETDs, if the clearing documents are not used, the typical master agreement used by clearing members gives clients no express rights should the clearing member default. Some dealers have argued that there is no reason for clients to object to the valuation term in the clearing documents, since it is no worse than under those existing ETD agreements. One imperfect agreement should not be a justification to agree to another, but more importantly the argument put forward by those dealers is incorrect. Given the silence in the typical ETD agreement as to what occurs should a clearing member default, normal English law principles apply in determining the rights of the client. A clearing member's default and non-performance of its obligations would amount to a repudiatory breach of contract. The general rule under common law is that the measure of loss that a party can claim for breach of contract is the value that the contract would have had to that party had the breaching party performed, which can include the cost of entering into new transactions to replicate the terminated contract. In the circumstances of a clearing member default leading to client derivatives being terminated where the ETD agreement is silent on the treatment of the client claim, it would be open to the client to claim for the replacement cost of the derivatives as a measure of the cost to the client of putting itself in the same position as if the clearing member had performed.

The clearing documents' use of the CCP termination levels may have been due to the reasonable concern that a clearing member cannot be seen to guarantee a CCP by giving a greater return to clients than the clearing member gets from the CCP, as this could lead to the CCP Contracts ceasing to be zero-risk weighted for regulatory capital under Article 306 of the EU Capital Requirements Regulation ("CRR")[8]. However, Article 306 concerns losses caused by a CCP default, and not a clearing member agreeing to pay a client's losses caused by the clearing member's default.

There is a limited exception where the approach to valuation of terminated derivatives in the clearing documents is required, but it is an isolated case. Eurex Clearing AG ("Eurex"), a major CCP, does require that clients which elect to use Eurex's Individual Clearing Model for an individual segregated account must use the Eurex termination values if derivatives fail to port on a clearing member default[7]. However, this is a rule that only applies to this account type at Eurex. The clearing documents apply this approach of using CCP termination values to all other account types at all CCPs, without the rules of the CCPs requiring this.

POTENTIAL FOR SYSTEMIC HARM

More broadly, the obligation on a client to make an excessive payment to the insolvent clearing member has a needless negative impact on the financial system. In the example above, the $25 that the client has to pay the insolvent Lehman Brothers is cash that will not reappear until the bankruptcy estate makes a distribution in years to come. A major clearing member default would likely see the financial system in crisis, and in those circumstances the further loss of liquidity for the client and the market as a whole caused by excessive payments to the insolvency estate risks adding to the stress.

The potential for loss for clients between the price at which clearing members accept the risk of replacing terminated CCP Contracts through the CCP default auction process and the price at which a client is able to re-hedge the terminated Client Derivative should not be understated. The notional size of Lehman Brothers' derivatives book has been estimated as being approximately $35 trillion at the time of default[9]. A CCP that needs undefaulted clearing members to take the market risk of a significant percentage of a large defaulted clearing member's cleared derivatives in a time of system-wide distress would likely receive poor offers for replacement derivatives. Similarly a client seeking to re-establish a derivatives hedge immediately following its clearing member defaulting would face poor offers from dealers.

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[7] Imposed by the *Clearing Conditions* of Eurex in Chapter I, Part 3, Subpart C, Number 2.1.2(7).

[8] Regulation (EU) No 575/2013. Article 306.1(c) of CRR provides that *"where an institution is acting as a financial intermediary between a client and a CCP and the terms of the CCP-related transaction stipulate that the institution is not obligated to reimburse the client for any losses suffered due to changes in the value of that transaction in the event that the CCP defaults, the exposure value of the transaction with the CCP that corresponds to that CCP-related transaction is equal to zero."*

[9] Kimberley Summe, *Misconceptions about Lehman Brothers' Bankruptcy and the Role Derivatives Played*, 64 Stanford Law Review Online 16 (28 November 2011).

CONCLUSION

There are strong arguments in favour of restoring a client's normal contractual position of having the right to claim for its losses under the industry clearing documents. Restoring these rights would not involve clearing members suffering harm. Further, restoring these rights would be an improvement to the functioning of the financial system in the testing times of a clearing member default. FIA and ISDA should engage market participants in a review of the clearing documents in this regard, one that would most appropriately lead to a restoration of the normal contractual right to claim for losses. In the interim, users of the clearing documents should seek to incorporate the client's contractual right to claim for losses on a negotiated bilateral basis.

CONTACT DETAILS

If you would like further information or specific advice please contact:

ROBERT DANIELL
SENIOR COUNSEL
DERIVATIVES AND TRADING
DD: +44 (0)20 7849 2807
robert.daniell@macfarlanes.com

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