KEY POINTS

- The proposal to clear CDS through a central counterparty ('CCP') is intended to mitigate counterparty default risk. However, the benefits should not be overstated.
- Each of the main CCPs takes a different approach to many of the issues relevant to margin protection and portability of transactions with each approach bringing with it differing levels of customer protection.
- No approach is perfect and customers need to undertake a careful analysis to determine the optimal structure.

Feature

Authors Nick Shiren and Assia Damianova

Transferring risk of OTC CDS to a central counterparty: are customers protected?

This feature highlights some of the legal issues surrounding the use of central counterparties ('CCPs'), from the point of view of customer protection.

The turbulence in the financial markets has led to a reassessment of the risks of derivatives and related financial products and structures. In an effort to procure a more effective operation of the derivatives markets, regulators and market participants have been working to improve market infrastructure and in particular, to mitigate settlement and counterparty default risks. A number of regulatory, legislative and industry initiatives have sought to address different aspects of the perceived lack of transparency, liquidity and efficiency in the credit default swap ('CDS') market.[1] One such initiative is the proposal to clear CDS through a CCP.

THE CLEARING HOUSE SOLUTION

A central clearing counterparty

A CCP operates by being 'a buyer for every seller and a seller for every buyer', inserting itself between counterparties of each CDS cleared. An end-user (say, a hedge fund) (a 'customer') will use a CCP member (say, a broker dealer) (a 'member') to clear CDS concluded with another counterparty (say, a bank, or another entity, also acting through a member, the original parties being referred to as 'counterparties'). If one member were to default under a CDS, the CCP will perform its obligations under such CDS as if no default occurred and the loss borne by the CCP will be shared between the CCP's members. Contracts are negotiated between the original counterparties and then submitted to the clearing house for validation and clearing. The CCP will then determine margin requirements for each of its members.

Perceived benefits of a CCP

The derivatives markets have long developed their own mechanisms for managing counterparty risk through:

- collateralisation of obligations (under industry standard documents such as credit support annexes and credit support deeds);
- set-off and netting mechanisms under the ISDA Master Agreements (the enforceability of which is generally supported by legal opinions commissioned and updated for ISDA for a significant number of jurisdictions);
- the ongoing standardisation of derivatives documentation and the CDS confirmation process; and
- portfolio compression initiatives, which focus on single name trades and involve the reduction in the overall size and the number of line items in credit portfolios.

One perceived advantage of a CCP, over and above the existing mechanisms of the derivatives markets, is in reducing the probability that the insolvency of one member would cause the failure of other market participants. It is thought that a CCP will reduce systemic and counterparty risks as the original counterparties to the CDS will not face each other any longer, but the CCP. The assumption is that the CCP's credit risk is preferable to counterparty risk, even though some commentators[2] have asserted that the large dealers (trading billions of US$ of CDS annually) have better capacity to sustain counterparty losses when compared with the existing CCPs.

A CCP may also increase netting efficiency across positions between counterparties thereby reducing both the amount of collateral required to be posted and the regulatory capital that banks must hold against such positions. A counterparty will be able to net its obligations to post collateral on the basis of its global exposure to the CCP by taking into account all such counterparty's CDS positions, without limitation to the positions held with one particular dealer. However, some commentators have suggested that netting across different asset classes of derivatives (not limited to CDS) between two counterparties is likely to be more efficient than netting between multiple counterparties across CDS only[3]. If CDS are cleared through a CCP but other swaps are not, a counterparty's collateral obligations in respect of CDS will be calculated on a gross basis without netting opportunities across the other asset classes. In recognition of this issue, on 8 September 2009 it was reported[4] that the Federal Reserve Bank of New York has received commitments from 15 major over-the-counter ('OTC') derivatives dealers setting specific target levels for expanding central clearing for OTC credit and interest rate derivatives.

The strength of the perceived benefits of the CCP proposal will ultimately depend on a number of factors including the profile of the members of the CCP, whether or not the CCP is adequately capitalised, how easy it would be for the CCP to raise new capital from its members if need be and an analysis of the relevant legal framework to determine the level of protection afforded to customers in the case of member insolvency.

Two key issues to be considered in analysing the protection afforded to customers in the case of member insolvency are: margin protection; and the ability to effect an orderly transfer of customer positions to another member. These issues require a detailed analysis of the rules of the relevant CCP and the laws of a number of jurisdictions – conflicts of law rules would likely dictate an analysis of the law where margin is located, the governing law of the CDS transactions, the law of the jurisdiction of incorporation of the member and of the CCP and the law of any other jurisdiction relevant in the insolvency of a member. This article does not attempt an all-encompassing analysis of these issues, rather, it highlights some of the core themes in customer protection; acknowledging that such protections could be further developed through the legislative and regulatory reforms which are currently being considered in a number of jurisdictions and at European level.

HOW SAFE IS CUSTOMER MARGIN? Issues to be considered

In the event of a member default, the immediate question for a customer would be whether they are entitled to the return of their margin. In determining such entitlement, a customer would need to analyse in respect of each type of margin provided: (a) whether margin was provided under a 'title transfer' arrangement or a 'security interest' arrangement; (b) whether a right to use or re-hypothecate has been granted by the customer; (c) whether margin has been properly segregated; alternatively, what happens on commingling with other assets; (d) the extent to which competing liens and set-off diminish the available margin.

Proprietary vs contractual rights

In the aftermath of the Lehman insolvency, many Lehman counterparties have not been able to procure the return of 'their' property, since they gave up their proprietary rights to collateral and were left only with personal claims against an insolvent entity for the return of 'equivalent collateral'. Counterparties who retained ownership rights in collateral and simply granted a security interest have fared better.

In the context of a CCP arrangement, upon the insolvency of a member, the distinction between proprietary and contractual claims is likely to have fundamental consequences to the customer's claim – contractual claimants will be unsecured creditors of the insolvent member whilst proprietary claimants would generally be able to recover their property ahead of unsecured creditors. This will require an analysis of the arrangements between the customer and the member to determine whether margin was provided under a 'title transfer' arrangement – where the customer has purported to transfer margin outright in return for a contractual right to the return of 'equivalent' margin; or a 'security interest' arrangement – where the customer has purported to retain a proprietary interest in the margin subject to a security interest in favour of the member.

Right to use margin

Where a customer has purported to retain a proprietary interest in the margin and to merely grant a security interest in favour of the member, if the customer has also granted to the member a right to use or a right to re-hypothecate the margin, this may have the unintended consequence of depriving the customer of any proprietary rights to the margin if the member does in fact use or re-hypothecate the margin. This would leave the customer with a contractual claim against the member for the return of margin.

Holding of margin

In a CCP arrangement, customer margin may be held with the member, at the CCP or with a third party custodian. If members are required to hold customer margin separately from their own assets, any tracing, ownership and priority aspects of the customer claims will be enhanced. However, if customer margin is held with the member and is commingled with assets of the member, then the ability of the customer to assert proprietary claims may be impaired. If customer margin is held with the member and is commingled with margin of other customers, the customer may be required to share with other customers in the event of a shortfall in custodial property.

Competing liens and set-offs

If customer margin is subject to liens and set-offs by the member beyond the scope of cleared transactions (for example, creating set-off rights in favour of member affiliates tends to be a common provision in dealer standard documents), the return of customer margin will be complicated and further delayed. This is because the entity holding the margin will be left uncertain as to the entitlements of the various parties with a claim to the same assets and may well be exposed to competing claims.

How well do the main CCPs protect customer margin?

In summary, it would be beneficial for the position of the customer if margin: (a) is held by the member under a 'security interest' arrangement; (b) is not subject to a right of use or re-hypothecation (except to the CCP as margin for customer trades); (c) is held away from the member in a segregated account; (d) is not commingled with assets of the member or other customer assets; (e) is not subject to competing liens and set-off rights.

On 30 June 2009, an *ad hoc* group (comprising both buy-side and sell-side members) formed at the behest of the Federal Reserve Bank of New York published the 'Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralised OTC Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin' (the 'Report') which analyses these issues in detail in the context of the specific rules relating to the major CDS CCPs. The Report draws a number of interesting conclusions,[5] but of primary concern to market participants is the conclusion that there is no common approach to many of the issues relating to customer margin and each approach brings with it differing levels of customer protection. For example, the Report notes that some CCPs use a title transfer approach, others use a security interest approach and yet others use a title transfer approach together with a trust. Most CCP arrangements commingle customer margin although a small number of CCP arrangements use segregated accounts.

EFFECTIVE PORTABILITY

In the event of a member insolvency, one desirable option which would eliminate the need to close-out positions (and the related costs) is the transfer of customer positions to another member. The Report[6] concludes that for some CCPs the portability analysis is quite strong (for example, CME[7] and LCH.C), but uncertainties still remain. There are concerns arising from the back-to-back principal trade structure of ICE[8] and the Report concludes that under the current rules of ICE Europe the portability analysis is unclear and legislative enhancement may be required.[9] Eurex's clearing rules provide for automatic termination of all customer positions upon the commencement of formal insolvency proceedings in respect of a member, which limits the transfer period for customer positions.[10]

At the European level and to the extent

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Nick Shiren is a partner in the Financial Services Group of the London office of Cadwalader, Wickersham & Taft LLP. His practice focuses on complex financing transactions involving a wide variety of asset classes. Email: nick.shiren@cwt-uk.com
Assia Damianova is Special Counsel in the Capital Markets department of the London office of Cadwalader, Wickersham & Taft LLP. Email: assia.damianova@cwt-uk.com

the directives are reflected in member states' legislation, the Settlement Finality Directive 1998[11] and the Financial Collateral Directive 2002[12] support the non-revocability of orders and the validity of transactions including netting arrangements after the commencement of insolvency proceedings. The Settlement Finality Directive aims to override insolvency laws that would otherwise interfere with settlement finality in eligible payment and securities systems, by stipulating that: (i) transfer orders for payments and securities which are entered prior to the insolvency order, are irrevocable; (ii) collateral in the clearing system is not to be affected by insolvency laws; and (iii) the rights and obligations of the clearing member are determined by the law of the clearing system. The scope of that directive, however, is narrow as it captures only securities settlement systems governed by the law of a member state and which are designated to the European Commission by that member state.

ONGOING REFORMS

Further consultation and reform is under way. The Report makes a number of recommendations in this regard. In particular, in respect of the European CCPs, the Report recommends[13] rules: (a) allowing members to re-hypothecate customer margin to CCPs without customers losing their proprietary interest in the margin on the member's insolvency; (b) enhancing the ability of CCPs to effect the novation of customer positions upon the member's insolvency; (c) permitting timely access for customers to their margin after the member's insolvency; (d) protecting customers against the risk of a member's failure to segregate money and assets; and (e) reducing the extent to which CDS clearing customers have to share in client money shortfalls.

A UNIVERSAL SOLUTION?

The increased use of clearing houses is perceived as a necessary measure in counterparty risk management. Those benefits, however, should not be overstated. Not all CDS products are suitable for clearing. The Turner Review notes that clearing and central counterparty systems will only be feasible for roughly 50-75 per cent of the CDS that is accounted for by standardised contracts – a large volume of bespoke contracts will continue to be traded in an OTC fashion. The counterparty risk for those products (as well as for legacy CDS) will continue to be managed on a bilateral basis. Even where CDS are cleared, some inherent risks associated with clearing, as outlined above, remain. ■

1 Examples are: the US Treasury's Framework for Regulatory Reform, 'Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation', 26 March 2009; the US Financial System Stabilisation and Reform Act of 2009; the FSA Discussion Paper 09/2 and the related Turner Review published on 18 March 2009 on the regulation of banks; the recent UK government report, 'UK international financial services – the future', May 2009; HM Treasury's publication on insolvency and regulatory reforms, 'Developing effective resolution arrangements for investment banks', May 2009; as well as the ongoing market initiatives of the International Swaps and Derivatives Association, Inc ('ISDA'), such as standardisation of the CDS trading conventions of North American and European CDS, the new procedures for CDS-related determinations and auction settlement (the so-called Big Bang Protocol and Small Bang Protocol) and the forthcoming ISDA Independent Amount Whitepaper.

2 Craig, Pirrong, 'The Clearing House Cure' in *Regulation*, Winter 2008-2009, page 34 *et seq.*

3 Darrell Duffie and Haoxiang Zhu, 'Does a Central Clearing Counterparty Reduce Counterparty Risk', available at http:/www.stanford.edu/~duffie~/DuffieZhu.pdf.

4 http://www.newyorkfed.org/newsevents/news/markets/2009/ma090908.html.

5 Under the rules applicable to CME Clearing ('CME'); the segregation of customer positions and related margin is seen as strong from the perspective of customers' legal rights to recover margin. (See Chapter I.A.1 of the Report). Under the rules of ICE Trust US LLC ('ICE'): (a) for US members, the segregation analysis is evaluated as quite strong (See Chapter I.A.2 of the Report); (b) English members will note that ICE has not received approval as a 'recognised overseas clearing house' although is currently applying for such status (ICE Clear Europe Limited has such approval), so its ability to transfer open positions of insolvent English members will be curtailed due to the application of certain mandatory provisions under English insolvency law. Nonetheless, the UK Financial Collateral Arrangements (No 2) Regulations 2003 affords legal protection to close-out and netting rights by provision for the continued effect of a close-out netting provision of a 'financial collateral arrangement' in certain cases where the collateral-provider or the collateral-taker is subject to winding-up proceedings or reorganisation measures such as administration. (See reg 12, even though there is some uncertainty the Regulation would apply to a close-out netting provision between more than two parties). Under the structure of Eurex Clearing AG ('Eurex'): (a) for US members and US customers of members, margin must be segregated by the member (and in certain instances must be pledged to the customer by the member), but the effectiveness of such arrangements in the event of the insolvency of a customer would need to be examined in each relevant jurisdiction; (b) for non-US customers, segregation of customer margin is not required by Eurex, but the clearer is in the process of considering the issue further, therefore the segregation requirements under Eurex's conditions are likely to be subject to change. The legal framework for ICE Clear Europe Limited ('ICE Europe') is still under development, but the proposal is to impose a requirement on members to hold on trust for customers any margin to which the customer may be entitled after the position is closed or novated. A concern remains, however, as margin is posted under a title transfer arrangement, that margin posted by customers might be absorbed into the member's general estate on insolvency.

6 See Chapter III of the Report.

7 See Chapter I.A.1 of the Report.

8 See Chapter I.A.2 of the Report.

9 See Chapter I.C.3 of the Report.

10 Prior to insolvency, Eurex positions may be transferred with the consent of all parties. In the context of Lehman Brothers International (Europe), Eurex was able to transfer customer positions prior to formal insolvency procedures.

11 98/26/EC as amended by 2009/44/EC.

12 2002/47/EC as amended by 2009/44/EC.

13 See Chapter I.C.3 of the Report.