

Consultation on changes to CREST Rule 13 Settlement finality in respect of complex transactions

1. The City of London Law Society ("**CLLS**") represents approximately 15,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to consultations on issues of importance to its members through its 17 specialist Committees.
2. The Financial Services Authority ("**FSA**") has asked the CLLS to consider the question of whether, if Euroclear UK & Ireland Limited ("**EUI**") continues to apply the "relation back" approach under CREST Rule 13 as outlined in its consultation document of November 2012:
 - (a) this would fall within the spirit of Directive 98/26/EC on settlement finality in payment and securities settlement systems as amended (the "**SFD**");
 - (b) the CREST rule as so drafted would fulfil the purpose of the SFD in providing increased default protection and reducing uncertainty and legal risk.
3. A joint working party of the CLLS Financial and Insolvency Law Committees has prepared this Note in response to the above questions. The role of the CLLS is to provide general comment and not to give legal advice on a specific situation. We have considered the questions from the perspective of the SFD as implemented into English law by the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 as amended (the "**SFRs**"). We have attended a presentation by EUI explaining the complex products referred to in its consultation document, particularly the Delivery by Value ("**DBV**") product,¹ and the alternative options for dealing with them under CREST Rule 13. We note that the "relation back" approach also applies under CREST Rule 13 in relation to transactions which are not DBV transactions – notably self-collateralising repo ("**SCR**") transactions, which are generated in support of auto-collateralisation contracts, and certain transactions that support CREST automatic claims and transformations functionality. We have not had an opportunity to discuss the issues with participants in or users of CREST.

¹ Overnight DBVs involve an overnight movement of collateral based on a specified amount of securities from a defined basket (e.g. £1m of FTSE 100 shares), usually against a cash payment. Equivalent collateral is returned the next day, against repayment of the purchase price (consideration) along with an optional interest payment. Term DBVs are similar to overnight DBVs but may be open for a period of days, weeks or months (up to two years). This introduces additional complexity because of the need to handle automatically the impact of corporate actions, other settlement requirements and mark-to-market adjustments. See the CREST consultation document at page 8.

4. We have not been asked, and do not propose, to consider the question of whether EUI has sufficient rule making power validly to adopt the "relation back" approach for the purposes of the SFRs. We assume that EUI has taken separate legal advice on this question and discussed the position separately with the FSA.
5. The "relation back" approach means that all transfer orders relating to one particular transaction (such as the constituent elements of a Term DBV) are treated as entering the CREST system at the point of entry of the initiating or originating transfer order for the original or linked transaction. We understand from EUI that the "relation back" approach is of most relevance where:
 - (a) the originating transfer order relating to a relevant transaction (e.g. a Term DBV transaction) with a corporate member of CREST was entered in the CREST system and only where it became irrevocable before the appointment of an insolvency practitioner (an "IP") as administrator, receiver or liquidator of the relevant CREST member;
 - (b) all instructions automatically generated within CREST in relation to the relevant transaction after the appointment of the IP would be ancillary or supplemental to the same transaction in the sense that they would solely implement or perform existing contractual requirements of (and existing mutual contractual rights relating to) the original transaction and would not involve a variation² of the transaction or the unilateral exercise by one party of any option or discretionary right or other step which could amount to a separate transaction;
 - (c) the CREST membership of the relevant CREST member would be disabled by EUI as soon as EUI became aware that an IP had been appointed in relation to that CREST member;
 - (d) no unsettled instructions would be performed, and no new instructions would be received, within CREST after the CREST member had been disabled unless the membership of the relevant CREST member was re-enabled by EUI;
 - (e) for all relevant purposes, EUI would agree to re-enable the membership only at the request of the IP and with the co-operation of the relevant member's CREST settlement bank (this is also supported by the guidance contained in CREST Rule 13); and
 - (f) any action taken by EUI in relation to re-enablement would only occur after close consultation with the FSA and the Bank of England.
6. On this basis it is difficult to see who would be unfairly prejudiced by the operation of the "relation back" approach. EUI would be unlikely to agree to re-enablement of membership if there was a risk of successful third party challenge. It would also need to be satisfied that re-enablement was in the interests of the system and the public interest, would reduce risk in the financial markets and promote wider financial stability, given its regulatory position as (i) a recognised clearing house (an "RCH") under the Finance Services and Markets Act 2000 and Part VII of the Companies Act 1989, (ii) an approved

² We understand that there may be cases where the original contractual terms provide a framework for the parties subsequently and *mutually* to determine an amendment to the terms of the original DBV transaction. This would occur if the parties (which would, as far as the insolvent member is concerned, mean the member acting through the IP) *agreed* to (1) increase, decrease or substitute collateral under a manual "TDS" transaction, or (2) adjust the DBV value sought and consideration under a manual "TDA" transaction. This would require the agreement of both parties and both parties would then manually input matching TDS or TDA instructions.

operator of a "relevant system" under the Uncertificated Securities Regulations 2001 as amended, (iii) an operator of a "designated system" under the SFRs and (iv) an operator of a recognised inter-bank payment system under Part 5 of the Banking Act 2009.³ The IP would be unlikely to agree to re-enablement unless he considered that re-enabling membership, so as to permit the settlement of pending transactions or generation of new instructions, would be in the interests of creditors as a whole. Where the member remained authorised under the applicable regulatory system, the IP would also need to have proper regard to the member's continuing regulatory obligations and related guidance from the relevant regulatory authorities.

7. If the member's transactions pending in CREST were too numerous and/or too complex for the IP to assess properly, he would be unlikely to decide to ask for or agree to re-enablement. In this case, counterparties would be free to seek to agree bilateral settlement outside CREST with the IP or to close out transactions and exercise their remedies (such as enforcement of collateral held outside CREST). The transactions would be deleted from the CREST system. We note that, in the case of Lehman Brothers International (Europe) ("LBIE") and MF Global, their CREST membership was not re-enabled following commencement of administration.
8. In contrast, the alternative solutions (i.e. the "moment of generation" approach⁴ and the "time delimited" approach⁵) would not offer the beneficial courses of action that might otherwise be available to EUI and an IP under the "relation back" principle in CREST Rule 13. We understand that in particular the "relation back" approach allows relevant transactions (whether DBV, auto-collateralising repo or other relevant transactions) to settle, where this is considered to be in the interests of the insolvent member and other participants – as well as enhancing the stability of the markets and promoting wider financial stability. Such settlement might not be possible if CREST Rule 13 adopted the "moment of generation" or "time delimited" approach. We understand that EUI regards these considerations as supporting its view that the "relation back" approach is consistent with the spirit of the SFD. EUI has taken advice on compatibility of the "relation back" approach with the SFD and been advised that it is compatible, having regard to the recitals of the SFD and the definition of "default arrangements" in the SFRs and the protection for them. The introduction of these provisions in the SFRs demonstrates an intention that operators of designated systems be able to take action to limit systemic and other risks which arise in the event of a participant insolvency.
9. Concern derives primarily from the potential application of *pari passu* distribution and anti-deprivation principles, and from section 127 of the Insolvency Act 1986 in relation to dispositions of securities held in CREST after the member enters insolvency. If these legal principles and provisions apply (or if there is a reasonable concern that they might apply) to invalidate a transfer of property through CREST, then settlement of the relevant transaction – even if considered desirable by EUI, the IP and the relevant regulatory

³ See "The Bank of England's approach to the supervision of financial market infrastructures" (December 2012) at pp 1 to 3.

⁴ The "moment of generation" approach treats each individual component of a complex transaction separately. Each instruction for a component transaction is defined as entering the system at either the moment it was received by the CREST Applications Host from a participant or, if it was automatically created, at the moment of that automatic creation. The various components of one Term DBV would therefore each have a different moment of entry, varying in time from the moment of original instruction receipt, through each day on which an amendment is made or required, potentially up to the agreed date the Term DBV closes out. See the CREST Consultation Document at page 34.

⁵ The hybrid "time delimited" approach would apply the "relation back" approach for a certain specified period, such that the moment of entry of transfer orders would be linked back to their originating or initiating transfer order during this initial period. However, after a defined period of time, the "relation back" approach would no longer be applied. After this defined period of time, the "moment of generation" approach could be applied, i.e. after the defined cut-off point, any subsequent transactions have a moment of entry defined by reference to their moment of actual creation or receipt.

authorities with regard to all relevant factors – might not be capable of being effected (or efficiently and confidently effected) without clear protection for the relevant transaction under the SFRs. Regulations 14(1) and 16(3) of the SFRs provide protection against the invalidating effect of these principles and provisions only if the relevant transfer order (which instructs the disposition) enters the system before the moment of opening of insolvency proceedings (regulation 20). The operation of regulation 20 would, therefore, potentially prevent the settlement of newly generated instructions under the "moment of generation" or similar approach. The SFRs would not apply to protect the settlement of the instruction from subsequent challenge. If the moment of entry "relates back" to the earlier initiating or originating instruction (where that preceded the opening of insolvency proceedings against the member), then regulation 20 would not prevent final, irreversible settlement of such instructions (on the basis of breach or potential breach of the above distributional principles or failure to obtain court sanction under section 127).

10. The potential concern created by the absence of SFRs protection might prove particularly marked if the insolvent member was in fact a settlement agent acting for a (solvent) contracting party to a DBV, auto-collateralising repo or other relevant transaction. In such a case, the IP might conclude that it would be consistent with his relevant statutory functions, and in his capacity as an officer of the court, to facilitate the transfer of assets (which he considers are beneficially held by the solvent contracting party) from the insolvent member's CREST account. However, if EUI was aware of conflicting proprietary claims to the assets held by the CREST member, we understand that EUI is unlikely to be willing to allow for settlement of a transaction resulting in the disposition of those assets unless satisfied on a number of matters, including the availability of SFRs protection to the post-insolvency disposition of the assets, legal title to which is held by the member. This would become relevant if it were subsequently determined that the relevant assets, or some of the relevant assets, were in fact beneficially owned by the insolvent member.
11. Where the CREST member's settlement bank had provided settlement bank services to the member on a secured basis, it may well hold a floating charge over CREST securities to which the CREST member was entitled. This floating charge would have crystallised on the appointment of the IP. The settlement bank might well have already taken steps under the fast-track enforcement procedure⁶ to realise sufficient charged securities to discharge its potential exposure as a settlement bank. A settlement bank would be unlikely to agree to settle further transfer orders on re-enablement, unless satisfied that it was adequately secured for this new exposure.
12. A counterparty to a Term DBV (or other relevant transaction) might stand to make a windfall gain or loss if the transaction was terminated prematurely. This would not occur if the CREST membership was re-enabled. If the "relation back" procedure operated, the original DBV Term transaction between the parties would be capable of being performed in accordance with its terms.
13. The position might be different if the "relation back" approach were to permit one party to a relevant transaction (e.g. a Term DBV) to input manual instructions into CREST to do something which amounted to a unilateral variation of the original contract or the exercise of a unilateral option or other discretionary right which altered the position of the parties. However, we understand from EUI that the design of the CREST functions applicable to relevant transactions (such as a Term DBV) is such that this is not possible.

⁶ See the CREST Reference Manual, Chapter 6, Section 7.

14. It therefore appears that, in straightforward situations, the impact of the "relation back" approach would not prejudice relevant parties, and might enable CREST settlement to occur where this is considered in the interests of the insolvent member and market participants and is consistent with the discharge of EUI's regulatory functions to enhance the stability of the financial markets and promote wider financial stability.
15. We recognise that, in a case such as LBIE where there could be a large number of DBVs and other complex products outstanding, the proper course might be extremely difficult to determine. There would be concern to avoid arbitrary and unpredictable results, particularly where there had been corporate events or even insolvencies of the underlying issuers of shares in the meantime. The result might vary depending on when the CREST membership was dis-abled and when it was re-enabled. However, the "relation back" approach as applied under Rule 13 means that these considerations are left to be determined by EUI, the IP and the regulatory authorities, in the light of the particular circumstances affecting the insolvent member.
16. We understand that EUI considers that participants should take comfort from the following:
 - (a) first, the regulatory system to which EUI is subject (and, in particular, having regard to the CPSS-IOSCO Principles for financial market infrastructures) requires EUI to exercise its default powers as regulatory functions fairly, transparently and in good faith, with due regard to any concerns expressed by all relevant stakeholders (including the IP and regulators);
 - (b) secondly, the IP himself, as an officer of the court subject to statutory obligations, could be expected to be highly sensitive to the proper performance of his functions in the interests of the general body of the member's creditors and/or proprietary claimants.
17. We recognise that there might be an increase in uncertainty during the period from the appointment of the IP until a decision was taken whether to re-enable. During this period the counterparty would be unclear whether a DBV Term (or other relevant) transaction would be settled in accordance with its terms through CREST or whether the counterparty would need to close out the transaction and claim for its loss. We understand that EUI would intend in such a case to set an early cut-off date (possibly even as early as the date of appointment) after which a decision whether to re-enable could not be taken, in order to reduce the period of uncertainty for the markets.⁷ We also understand that re-enablement of the insolvent member (if it is agreed by EUI and the IP) would only occur for such period as may be necessary or appropriate to manage the systemic and other risks created by a member's insolvency. EUI believes that in practice re-enablement is unlikely to occur for extended periods.
18. The above uncertainty applies in particular to Term DBV transactions because they have a life cycle of days, weeks or months (up to two years). It is much less of a problem in relation to overnight DBV transactions or auto-collateralisation arrangements. The latter arrangements provide a mechanism for the intra-day repo of securities from CREST members to settlement banks and from settlement banks to the Bank of England in order to create additional intra-day liquidity within CREST. These DBV and repo transactions are automatically unwound by CREST at the end of the same day or at the start of the next day. The "relation back" approach would be beneficial in ensuring that instructions

⁷ In this respect, we understand that guidance on the way in which EUI can be expected to act in these circumstances is specifically incorporated into CREST Rule 13.

for the return of securities were fully protected, given the huge volume of cash and securities moving within CREST each day under these DBV and repo arrangements.

Financial and Insolvency Law Committees
The City of London Law Society
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Membership of the Working Party of the CLLS Financial and Insolvency Law Committees

This Note has been prepared, on behalf of the CLLS Financial and Insolvency Law Committees, by the following working party:

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