

Allen & Overy LLP

To Owen Taylor
LCH.Clearnet Limited

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Allen & Overy LLP

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Date as of 26 September, 2016

Subject **LCH.Clearnet Limited SwapClear Service – STM Contracts – Responses to SEC Queries**

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1. INTRODUCTION

1.1 In 2015 we were instructed by you, LCH.Clearnet Limited (**LCH**), to act as your legal adviser as to matters of English law in relation to the development and implementation of the SwapClear STM Contract (as defined below). The SwapClear STM Contract was formally introduced in December 2015.

1.2 We understand that the ISDA Accounting Committee approached the Securities and Exchange Commission (the **SEC**), submitting a white paper regarding certain accounting points impacted by SwapClear STM Contracts, and that the SEC has requested an additional submission to be prepared by ISDA on behalf of certain banks (the **Banks**), addressing each of the following questions in relation to SwapClear STM Contracts:

- (a) What are the key elements of the legal opinion that will be necessary to inform the accounting conclusion that the derivative, variation margin and PAA are one unit-of-account? (**Question 1**)
- (b) How did the legal rights / obligations to variation margin under CTM change when compared to STM? Consider explaining, for example, how a derivative counterparty had a legal right to variation margin paid under CTM (and how those rights could be exercised throughout the derivative's term), and how those legal rights will be eliminated under STM when the payment of variation margin is considered a settlement of the derivative's MTM. (**Question 2**)
- (c) Why did clearing members deem it necessary to obtain a legal opinion that the derivative's MTM was settled under STM, but not determine that a legal opinion was necessary to treat variation margin / PAI as a separate unit-of-account from the derivative under CTM (based on our last discussion, it sounded like a legal analysis was not a factor in determining the accounting treatment under CTM)? (**Question 3**)

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- 1.3 You have instructed us to consider these questions and, to the extent the questions relate to matters of English law only, draft a proposed response for you to consider. Our proposed response is subject to the following qualifications:
- (a) we have been instructed solely by LCH. We have not taken any instructions from any other person, including but not limited to ISDA or the Banks, and no client-attorney relationship exists between those institutions (either collectively or any of them individually) and us;
 - (b) the proposed response has been prepared for LCH. LCH may, if it considers it appropriate, provide ISDA and/or the Banks with this proposed response for their consideration;
 - (c) the proposed response is generic in nature; we have not considered whether it is appropriate for, or responsive to the concerns of, any particular Bank. It is the responsibility of each individual Bank to determine whether the proposed response is appropriate;
 - (d) some of the SEC's questions reference prior conversations to which we were not a party. We have not sought to verify the content of those conversations and we make no assurances as to whether our proposed response is consistent with those conversations;
 - (e) some of the SEC's questions reference accountancy concepts or require accountancy analysis. We can only answer the questions to extent they relate to matters of English law. Any accountancy analysis is beyond the scope of our engagement and should be conducted separately by the Banks or LCH; and
 - (f) the proposed response is based on the General Regulations (as defined below) and other related documents in force as at the date of this document, and we are under no duty or obligation to update the proposed response or the SEC after the date of this document.

- 1.4 Capitalised words used but not defined in this document shall, unless the context requires otherwise, have the meaning given to them in the general regulations of LCH (the **General Regulations**), which are publicly available on LCH's website.

2. **QUESTION 1**

What are the key elements of the legal opinion that will be necessary to inform the accounting conclusion that the derivative, variation margin and PAA are one unit-of-account? (Question 1)

- 2.1 We cannot comment on the meaning of the term "one unit of-account" as it is not a legal concept. Nor can we comment on how any accounting conclusions may be reached in the context of SwapClear STM Contracts. However, please refer to the answer to question 2 where we have summarised the key legal differences between a SwapClear CTM Contract and a SwapClear STM Contract, and the answer to question 3, where we have described the legal opinions that LCH has commissioned in relation to SwapClear STM Contracts and summarised the key conclusions of those legal opinions.

3. **QUESTION 2**

How did the legal rights / obligations to variation margin under CTM change when compared to STM? Consider explaining, for example, how a derivative counterparty had a legal right to variation margin paid under CTM (and how those rights could be exercised throughout the derivative's term), and how those legal rights will be eliminated under STM when the payment of variation margin is considered a settlement of the derivative's MTM.

- 3.1 We assume this question is asking for a summary of the key differences in the legal rights and obligations that exist under a SwapClear CTM Contract versus those that exist under a SwapClear STM Contract. The proposed response below is based on that assumption.
- 3.2 It is understood in both the cleared and uncleared over-the-counter derivatives market that there is a difference between derivatives that are structured and documented as "collateralised-to-market" derivatives and those derivatives that are structured and documented as "settled-to-market". Although these terms have not, to our knowledge, been given a particular legal meaning under English or EU law, we understand they are used by market participants to differentiate between two classes of derivative contract that use a fundamentally different legal basis to achieve a consistent commercial purpose, namely to mitigate or extinguish the counterparty credit risk arising from movements in the mark-to-market value of a derivative.
- 3.3 Although the commercial purpose of "collateralisation-to-market" and "settlement-to-market" may be the same, the legal nature of the rights and obligations of the parties to such contracts fundamentally differs between the two models.
- 3.4 We note that LCH introduced its "settlement-to-market" cleared interest rate swap model through creating an entirely new form of SwapClear Contract (the **SwapClear STM Contract**) which contains fundamentally different legal rights and obligations from those that exist under a "collateralised-to-market" contract (the **SwapClear CTM Contract**). A summary of the key legal differences that exist between these contract types is set out in the remainder of this Section 3.
- 3.5 *SwapClear CTM Contracts*
- (a) If the net present value (or mark-to-market exposure) of a SwapClear CTM Contract has increased (i.e. moved in favour of LCH) since the previous determination, then the SwapClear Clearing Member is obliged, pursuant to the General Regulations and related documents, to transfer to LCH

cash with a value equal to the amount of such increase. The converse is also true. This, in short, is the variation margin obligation.

- (b) Both LCH and the SwapClear Clearing Member agree that any transfer of cash which is made to satisfy the variation margin obligation of one party is for the purpose of collateralising the obligations that it owes to the other party under that SwapClear CTM Contract. Such transfer is not made for the purpose of settling any obligation or exposure that arises under that SwapClear CTM Contract. This distinction is expressly set out in Regulation 57(c) and finds further support in 1.7 of the Procedures (Section 2C).
- (c) For present purposes it is important to note that a party's exposure to its counterparty under a SwapClear CTM Contract is not reset, diminished or extinguished during the life of the derivative by payment of cash to discharge the variation margin obligation. Instead, the exposure of one party to the other remains in existence on a given day, and is collateralised by the transfer of cash by the other party.
- (d) The net amount of cash that has, at a given point time, been transferred between the parties to a SwapClear CTM Contract forms part of the "collateral balance" associated with that SwapClear CTM Contract, and is recorded in the books and records of LCH as such. Cash transferred in satisfaction of the variation margin obligation comprises at least part of what LCH refers to as the "Collateral". We understand that SwapClear Clearing Members also separately record on their books and records the movements in exposure relating to a SwapClear CTM Contract and the corresponding movements in collateral held relative to such exposure.
- (e) On termination of a SwapClear CTM Contract one party will (ordinarily) have an obligation to pay a close-out amount to the other. If, for example, a SwapClear Clearing Member has an obligation to pay a close-out amount to LCH upon termination of a SwapClear Contract, LCH shall apply the amount of cash collateral it holds in relation to such contract to discharge the SwapClear Clearing Member's obligation to pay the close-out amount. The manner in which LCH would in practice discharge the obligation of the Clearing Member to pay the close-out amount is by the acceleration of LCH's obligation to return the cash collateral held on such day to the Clearing Member and the subsequent set-off of that accelerated return obligation against the obligation of the Clearing Member which is to be discharged. This requires that there is a legally enforceable close-out netting and set-off arrangement in existence between the parties.

3.6 *SwapClear STM Contracts*

- (a) LCH introduced two primary new contract terms in order to create a SwapClear STM Contract. These terms are not included in a SwapClear CTM Contract.
- (b) The first new provision obliges LCH to determine the net present value of a SwapClear STM Contract on at least a daily basis. Immediately upon making this determination two things automatically occur under the terms of the SwapClear STM Contract:
 - (i) a contractual debt obligation arises and is owed to the party in whose favour the net present value has moved for an amount of cash equal to the absolute value of the change in the net present value; and
 - (ii) the net present value of the SwapClear STM Contract is reset to zero.
- (c) For example, if the net present value of a SwapClear STM Contract has increased by "X" since the last determination, the net present value of the SwapClear STM Contract is immediately reset to zero and the SwapClear Clearing Member shall be obliged to immediately pay cash with a value of "X" to LCH. If on the following day, the net present value of a SwapClear STM Contract has decreased

by “Y”, the net present value of the SwapClear STM Contract shall again be immediately reset to zero and LCH shall be obliged to immediately pay cash with an absolute value of “Y” to the SwapClear Clearing Member.

- (d) Payment by one party to the other of the amount owed under this provision is in full and final settlement of the contractual debt obligation that has arisen under the SwapClear STM Contract, and is made to settle the realised profit or loss that has been created by the change in the mark to market value of the SwapClear STM Contract. Subject to certain insolvency principles beyond the scope of this document (but which are addressed in the Contract Opinion referred to at paragraph 4.6 below), there is no obligation upon the recipient of a payment under a SwapClear STM Contract to repay or return such amount in any circumstance – this is in contrast to a SwapClear CTM Contract.
- (e) It is significant that the reset in the net present value of the SwapClear STM Contract occurs immediately upon the determination of the change in net present value by LCH, and is not expressed to occur following the payment of the resulting NPV Amount. The reset of the net present value of the SwapClear STM Contract can therefore be said to occur automatically and on a daily basis.
- (f) The second new provision introduces a payment obligation called the “Price Alignment Amount”. This cash-flow replicates the economic effect of Price Alignment Interest, which LCH pays or receives on a daily basis in connection with SwapClear CTM Contracts. A fuller description of the economic purpose of Price Alignment Amount and Price Alignment Interest is contained in the Contract Opinion (as defined below), but does not have relevance for the purpose of comparing and contrasting SwapClear CTM Contracts and SwapClear STM Contracts. In short, although both Price Alignment Amount and Price Alignment Interest are calculated by reference to economically equivalent values, they have important legal differences consistent with their characterisation as belonging to contracts that are “settled” versus “collateralised” respectively.
- (g) Under a SwapClear CTM Contract, the amount of Price Alignment Interest is calculated by reference to the actual net cumulative amount of cash variation margin a given party has actually received from the other in connection with a SwapClear CTM Contract. The obligation to pay Price Alignment Interest is contained in the LCH Procedures, and is not a term of the SwapClear CTM Contract. In contrast, under a SwapClear STM Contract, the amount of Price Alignment Amount that a party has to pay to the other has to be determined by reference to a “hypothetical” cumulative net present value, because there is no actual collateral balance to calculate it by reference to. In addition, Price Alignment Amount is a payment obligation under the terms of a SwapClear STM Contract (i.e. it is embedded) and therefore it is determined, discharged, and reset on a daily basis. These two differences between Price Alignment Interest and Price Alignment Amount are important when considering the characterisation of a SwapClear STM Contract versus a SwapClear CTM Contract.
- (h) Regulation 57A(a) of the General Regulations provides that neither LCH nor a SwapClear Clearing Member shall be under any obligation to make any payment by way of variation margin in respect of a SwapClear STM Contract. Or put another way, there is no variation margin obligation in respect of SwapClear STM Contracts because all of a party’s mark-to-market exposure to the other has been fully and finally settled on a daily basis, as described above.
- (i) The definition of “Collateral” and related definitions in the General Regulations captures cash and other assets one party has transferred to the other to discharge a margin obligation. The definition of “Collateral” and related definitions expressly exclude those amounts transferred between the parties for the purpose of settling their obligations under a SwapClear STM Contract. The effect of this is that neither party “holds” any collateral in respect of the other party’s obligations under a SwapClear STM Contract; there is no “collateral balance” associated with a SwapClear STM Contract.

- (j) On termination of a SwapClear STM Contract the determining party must determine the “outstanding” or “unsettled” net present value of that contract at the relevant point in time and such amount would be payable by the applicable party. This would ordinarily represent the change in the net present value of the SwapClear STM Contract since the last settlement payment was made by either party. In contrast to a SwapClear CTM Contract there is no netting or set-off of amounts of cash collateral held by one party as collateral for the other’s obligations, because no such collateral will have been provided in connection with such a contract in the first place.

4. QUESTION 3

Why did clearing members deem it necessary to obtain a legal opinion that the derivative’s MTM was settled under STM, but not determine that a legal opinion was necessary to treat variation margin / PAI as a separate unit-of-account from the derivative under CTM (based on our last discussion, it sounded like a legal analysis was not a factor in determining the accounting treatment under CTM)?

- 4.1 We cannot comment on why SwapClear Clearing Members deemed it necessary to request the legal opinions they did. However, we have set out below a summary of the opinions that were commissioned by LCH and their conclusions.
- 4.2 It should be noted that neither of the opinions commissioned by LCH are, to our knowledge, required by law or regulations applicable to it or its SwapClear Clearing Members. Further, the legal principles underpinning SwapClear STM Contracts (as summarised above) would not be any different if the opinions had not been commissioned.
- 4.3 It should also be noted that the key legal principles underpinning the collateral mechanism that exists in relation to SwapClear CTM Contracts are very closely aligned to those legal principles underpinning collateralised over-the-counter derivatives. As collateralised derivatives are so widely traded (both in a cleared and over-the-counter context), market participants are familiar with these legal principles and the legal opinions that are required to support them. For example, the key legal opinion required to support collateralised derivatives (both over-the-counter and cleared) is ordinarily one confirming the existence of valid and enforceable netting and, if relevant, security provisions. Derivative contracts that are settled-to-market (such as the SwapClear STM Contract) are currently less widely traded and the legal principles underpinning them are fundamentally different. It follows that the legal opinions market participants have sought in relation to such contracts are also different. For example, it is not relevant for market participants to consider netting and security arrangements in respect of collateral in the context of a SwapClear STM Contract because such a contract is not collateralised.
- 4.4 Finally, please note that neither of the above legal opinions consider or opine on the accountancy treatment of SwapClear STM Contracts. In fact, there is an express qualification stating this in the Contract Opinion and the CRR Opinion.¹ In addition, neither of the above legal opinions considers nor opines on whether a SwapClear STM Contract is capable of any particular regulatory capital treatment, and there is an express qualification stating this in the Contract Opinion and the CRR Opinion.² It falls to each individual SwapClear Clearing Member to form its own view on the accountancy and regulatory capital implications of entering into (or converting existing portfolios into) SwapClear STM Contracts.
- 4.5 LCH commissioned two legal opinions in relation to the SwapClear STM Contract. The first legal opinion (the **Contract Opinion**) considered (a) the enforceability, under English law, of certain provisions of the SwapClear STM Contract, (b) the legal effect, under English law, of those

¹ Please see paragraph 7(h) of the Contract Opinion, which is incorporated by reference into the CRR Opinion.

² Please see paragraph 7(g) of the Contract Opinion, which is incorporated by reference into the CRR Opinion

provisions of a SwapClear STM Contract, and (c) how a SwapClear STM Contract would be characterised by an English court applying English law. The second legal opinion (the **CRR Opinion**) was largely interpretative and considered whether, as a matter of English law (including certain EU laws with direct effect in England), a SwapClear STM Contract satisfies certain aspects of Article 274(2)(c) of the Capital Requirements Regulation (**CRR**).

4.6 *The Contract Opinion*

- (a) The Contract Opinion concluded that, as a matter of English law, and subject to certain qualifications and assumptions:
- (i) the terms of a SwapClear STM Contract are reset so that the net present value (as determined by LCH) of that SwapClear STM Contract would immediately be reset to zero;
 - (ii) the Price Alignment Amount and NPV Amount accrued since LCH's last determination of the same would become immediately due and payable by the applicable party upon LCH's determination of those amounts;
 - (iii) the full and final discharge of the Price Alignment Amount and NPV Amount by the applicable party would be in settlement of that party's outstanding exposure (as determined by LCH) under that SwapClear STM Contract;
 - (iv) neither party to a SwapClear STM Contract would be under any express or implied contractual obligation to repay the NPV Amounts or Price Alignment Amounts received from the other party;
 - (v) the key provisions of a SwapClear STM Contract constitute legal, valid, binding and enforceable obligations; and
 - (vi) an English court, applying English law, would give effect to the intentions of the parties to a SwapClear STM Contract (as such intentions are documented) and would not recharacterise a SwapClear STM Contract.

4.7 *The CRR Opinion*

- (a) The CRR Opinion confirmed that, in our opinion, and subject to certain assumptions and qualifications, a SwapClear STM Contract is structured to settle outstanding exposure following specified payment dates, and that the terms of a SwapClear STM Contract are reset so that the net present value (as determined by LCH) of the contract is zero on those specified dates.
- (b) The CRR Opinion did not consider whether resetting the net present value (as determined by LCH) of the contract to zero means that the "market value" of that contract has been reset to zero, nor what is meant by "market value", on the basis that these are not legal questions.
- (c) The CRR Opinion was prepared by reference to CRR only, and not by reference to the capital requirements legislation of any other jurisdictions.

5. **DISCLOSURE; RELIANCE; NO LEGAL ADVICE**

- 5.1 This document is addressed to LCH only but may be shown by LCH to any of the Banks on the basis that we assume no duty of care or other responsibility whatsoever to any such recipient or any liability whatsoever as a result, or otherwise.
- 5.2 Nothing in this document constitutes legal advice and it should not be construed as such.