Legal high Committee for Financial markets of Paris

OPINION

of the Legal High Committee for Financial Markets of Paris (HCJP) on the legal feasibility of developing an interest rate derivatives clearing service in Paris

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OPINION OF THE LEGAL HIGH COMMITTEE FOR FINANCIAL MARKETS OF PARIS (HCJP) ON THE LEGAL FEASIBILITY OF DEVELOPING AN INTEREST RATE DERIVATIVES CLEARING SERVICE IN PARIS

In this Opinion, in accordance with the customary practice of European Union law, central counterparties will, in general, be designated by the acronym **"CCPs",** and central counterparties authorised within the European Union and recognised as qualifying central counterparties within the meaning of the Capital Requirements Regulation[1] will be designated by the acronym **"QCCPs".**

SUMMARY OF THE HCJP'S RECOMMENDATIONS AND OPINIONS

In general, the HCJP concludes that an obligation to relocate (the) clearing of interest rate transactions to the EU would be opportune, and that it is in the interest of the French market to promote the creation of such a clearing service in Paris.

1/ However, were such a rule to be adopted, it would be recommended for it to include a grandfather clause which could coincide with the effective date of the United Kingdom's exit from the Union.

2/ Rather than a single effective date applicable to the entire asset class, a gradual phasing in of the obligation should be preferred; it should define implementation criteria in consultation with the industry, based on, for example, the legal status of the counterparties, the characteristics of the products and/or their maturity.

3/ Allowing existing positions to be cleared in offshore CCPs pursuant to a grandfathering, would require adopting a transitional regime to avoid penalising the European market operators that ensure regulatory compliance with the requirements of EMIR and prudential performance in accordance with the CRR.

4/ Except for the overly restrictive conditions for membership in French CCPs, the HCJP did not identify any legal impediments that would prevent adopting a requirement to relocate trades or transfer existing positions cleared outside the EU to France. However, France should quickly initiate a project aimed at relaxing its requirements for becoming a CCP member.

[1] *Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.*

5/ The context of Brexit and the type of interest rate derivatives transactions are favourable factors for promoting French law as the law governing the clearing of these trades in French CCPs. Alternatively, the mechanism that LCH SA has set up for its CDS service, which applies both English and French law, could provide a useful precedent.

6/ On the issue of the jurisdiction of the French courts, the HCJP reiterates the analyses and conclusions of the "Report on the implications of Brexit on judicial co-operation in civil and commercial matters", which was published on 30 January 2017. The recommendations therein to modernise the French courts should be implemented and will be of use in promoting the exclusive jurisdiction of the French courts to resolve disputes in relation to clearing activities of French QCCPs, regardless of the applicable law.

NB: All of these recommendations and opinions are subject to change depending on the course of the negotiations between the United Kingdom and the Union on the terms of Brexit.

The interest rate derivatives market in the European Union (**"EU"**) is currently dominated by the United Kingdom. The London financial markets handle over 80% of the volume of $1.5 trillion in interest rate derivatives trades in the EU.[2]

In the case of over-the-counter (**"OTC"**) interest rate derivatives,[3] nearly all transactions are cleared by LCH Limited in London.[4] Its SwapClear service clears nearly 99% of OTC interest rate swaps in the EU.[5] On the continent, Eurex Clearing AG, a subsidiary of Eurex in Frankfurt, BME Clearing in Spain, Nasdaq Clearing AB in Sweden and KDPW in Poland clear a small share of trades in this asset class.[6]

[2] *Bank for International Settlements (BIS), "Triennial Central Bank Survey, OTC interest rate derivatives turnover in April 2016", p. 11.*

[3] *OTC trades represent nearly 90% of all derivatives trades in Europe (European Securities and Markets Authority (ESMA), "Risk assessment on temporary exclusion of exchange traded derivatives from Articles 35 and 36 of MiFIR", 4 April 2016, pages 7 et seq.). Therefore, this opinion will focus essentially on this asset class.*

[4] *The statistics on the volumes of transactions cleared by SwapClear are available at the following address: http://www.lch.com/fr/asset-classes/otc-interest-rate-derivatives/volumes/daily-volumes-swapclear-global.*

5 Vivien Levy-Garboua, "Organisation of market infrastructures in Europe" (L'organisation des infrastructures de marché en Europe), Report to the French Treasury Department, October 2016, p. 24.

[6] *ESMA, "Risk assessment on temporary exclusion of exchange traded derivatives from Articles 35 and 36 of MiFIR", op. cit., p. 12; "Public Register for the Clearing Obligation under EMIR", updated 8 February 2017 https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf.*

Currently, 20 German banks and 15 French banks are members of QCCPs located in London.[7]

Over 30% of the volume of OTC interest rate derivative trades cleared by SwapClear is denominated in euros,[8] compared to only 9.1% in sterling. Other European currencies account for a marginal share of volumes.

The current regulatory framework applicable in the EU to the clearing of OTC interest rate derivatives is essentially derived from European Regulation No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), which was published in the Official Journal of the EU on 27 July 2012 and entered into force on 16 August 2012 (**"EMIR"**) and its implementing legislation. In particular, euro-denominated[9] OTC interest rate derivatives must be cleared through QCCPs[10] in the case of the following instruments:[11] (i) fixed-to-floating interest rate swaps, (ii) basis swaps, (iii) forward rate agreements (**"FRAs"**) and (iv) overnight index swaps.[12]

QCCPs entitled to clear these product classes must be authorised by a competent authority in an EU Member State and are subject to requirements concerning their organisation (shareholder structure, governance, etc.) and conduct (transparency obligation and obligation to segregate assets and positions, etc.), as well as prudential requirements (management of exposures and margin calls, collateral requirements, guarantee funds, etc.), which have been harmonised within the EU by EMIR.[13] The European Securities and Markets Authority (**"ESMA"**) keeps an up to date register of QCCPs, which includes LCH Limited.[14]

[7] *International Regulatory Strategy Group (IRSG), "CCPs post-Brexit, Implications for the users of financial markets in the UK and EU 27", pp. 3 and 14.*

[8] *The figures are available on the SwapClear section of the LCH website, at the address given above.*

[9] *The obligation to clear interest rate derivatives also applies to products denominated in sterling, yen and dollars, as well as in the currencies of Poland, Norway and Sweden, in accordance with the provisions of Regulation (EU) 2015/2205 and Commission Regulation (EU) 2016/1178 of 10 June 2016 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation.*

[10] *The obligation to clear contracts through an authorised central counterparty applies to non-financial counterparties above a certain clearing threshold and to financial counterparties located in the EU, but also to counterparties established in third countries if the relevant contract has a direct, substantial and foreseeable effect within the Union (Articles 4 and 10 of EMIR).*

[11] *The schedule for implementing this obligation is progressive and runs from 21 June 2016 to 21 December 2018.*

[12] *Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation, Annex.*

[13] *Articles 14 to 50 of EMIR.*

[14] *Article 22 §4 of EMIR.*

However, QCCP status is not limited to EU CCPs. ESMA is authorised to recognise offshore CCPs in the EU, *i.e.* CCPs established in a third country,[15] if the European Commission has adopted an equivalence decision concerning the regulatory regime applicable to CCPs in the relevant third country. The Commission has adopted such equivalence decisions for the United States, Canada, Switzerland, South Africa, Mexico and South Korea. When such recognition is granted, offshore CCPs may provide clearing services in the EU. Market players may use these CCPs to clear their OTC derivative transactions as required by EU law, but such CCPs will be regulated and supervised solely by their home jurisdiction. CCPs recognised under the EMIR process also obtain QCCP status throughout the EU pursuant to the Capital Requirements Regulation (CRR).[16] This means EU financial institutions may apply a lower risk weighting to their exposures to these QCCPs when calculating their own regulatory capital.

The withdrawal of the United Kingdom from the EU (**"Brexit"**), which is scheduled for March 2019, is likely to cause significant change in the current operation of the derivatives clearing market.

When the United Kingdom ceases to be an EU member, unless transitional agreements and future co-operation procedures are negotiated by the British and European authorities, it is possible that when Brexit takes effect the CCPs located in London will no longer be recognised as QCCPs within the meaning of the EMIR and CRR regulations. Without considering the issue of whether British regulations are or will be deemed by the European Commission to be "equivalent" to those of the Union, without a transitional agreement, the United Kingdom will not be entitled to the equivalence regime before Brexit takes effect. This regime is available only to third countries. Similarly, before Brexit takes effect, no London CCPs will be able to request recognition by ESMA granting QCCP status.

The legal ramifications of the loss of QCCP status for CCPs located in London, in particular LCH Limited, are probably difficult to ascertain completely. However, it is at least clear that this situation would require market participants subject to EMIR to transfer the clearance of interest rate derivatives, for which European regulations impose a central clearing obligation, to a European or foreign QCCP (for example, certain US CCPs have been granted this status by ESMA). In addition to regulatory risks incurred in the event of non-compliance with the requirements of EMIR, the CRR would subject credit institutions and investment firms that fail

[15] *Article 25 of EMIR. ESMA has recognised the equivalence of about 40 third-country central counterparties. The list thereof is available at the following address: https://www.esma.europa.eu/sites/default/files/library/ list_of_applicants_ tc-CCP.pdf.*

[16] *Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.*

to make such transfer to very unfavourable prudential rules on their exposures to these CCPs if they continue to clear their interest rate derivative transactions through a CCP that does not have QCCP status.[17] Even without a requirement making clearing in the EU compulsory, this situation alone should encourage them to clear their transactions within the EU or through a third country QCCP.

For the sake of completeness, it should be pointed out that CRR (Article 497) provides for a transitional regime for third country CCPs, which enables them to be treated as QCCPs for CRR purposes, even if they are not yet recognised as such. This "transitional" regime, which applies only for CRR purposes, was originally intended to last 15 months, but has already been extended four times by the Commission.

Without prejudice to the terms of any transitional agreement between the United Kingdom and the EU, non-EU clearing has recently drawn the attention of numerous commentators, who have voiced significant sovereignty and security concerns, justifying a transfer of such services to the European Union. On the issue of sovereignty, these concerns are essentially justified for the clearing of transactions in EU sovereign securities and, in particular, the repo market therein. With respect to security, it is worth noting that CCPs that operate in central bank money (rather than commercial bank money) are clearly superior for systemic risk management purposes. Such CCPs are able to settle both monetary legs of all transactions they clear and, in the event of an emergency, if approved by the Governing Council, they may be entitled to refinancing from the central bank of issue (up to the amount of their available eligible collateral).[18] On the other hand, CCPs that operate outside the monetary area of the currency of the financial instruments they clear can, in principle, obtain that currency only through commercial agreements with the credit institutions of the relevant area, which are potentially subject to resolution or insolvency incidents. These two factors have led several European regulators to ask whether it would be desirable to amend European law to require that certain transactions be cleared through QCCPs located in the EU or whose characteristics satisfactorily address the issues described above.

In either case (loss of QCCP status and/or a rule requiring interest rate derivatives to be cleared in the EU),[19] it is foreseeable that, post-Brexit, the markets and market operators would transfer massive volumes of transactions currently cleared in London to the EU.

[17] *See, in particular, Article 300 et seq. of the CRR.*

[18] *Furthermore, only CCPs that have the status of credit institution are entitled to "routine" credit facilities from the central bank, if eligible collateral is deposited. The two matters are not necessarily linked.*

[19] *In principle, when Brexit takes effect, the loss of QCCP status by all British CCP is inevitable, at least temporarily. However, such loss of status is unrelated to the issue of whether the EU should impose an obligation to transfer clearing services to the EU.*

The HCJP was not asked to provide an opinion as to whether it would be appropriate or adequate to adopt such a rule. Moreover, at this point, it is premature to assess the chances that such a rule will be adopted because the revision of EMIR is in progress and the draft regulation on the recovery and resolution of CCPs is still at the consultation stage. Therefore, for the purpose of this study, this report will simply assume that such a rule is possible and, based thereon, will consider (i) if requiring that all current transactions cleared outside the EU be transferred to QCCPs within the EU is a necessary condition for adopting such rule; (ii) if such transfers are legally possible; and (iii) if such transfers are possible in practice and, if so, in what manner.

Under these circumstances, on 12 January 2017, the Banque de France, in connection with its leadership of the *Groupe des Infrastructures de Place* (Market Infrastructures Group), requested the HCJP to review a list of legal issues it deemed essential to assess the legal feasibility of developing this new activity on the continent and, more specifically, in Paris. The Banque de France requested that the HCJP provide its opinion on these issues by the end of March 2017.

The issues the HCJP has been asked to address fall into three areas: (i) a review of the legal feasibility of transferring interest rate derivative transactions currently cleared in London to the continent and, more specifically, to Paris; (ii) the possibility of promoting the use of French law for interest rate derivative transactions; and (iii) the advisability of requiring that interest rate derivative clearing disputes be submitted to the French courts.

The HCJP put together a **"Brexit and market infrastructures"** working group chaired by Alban Caillemer du Ferrage, for the purpose of studying the issues raised by the Banque de France in its assignment memorandum.

The working group met four times, on 19 January, 1 February, 23 February and 8 March 2017.

On 23 February 2017, it interviewed various members of the legal departments of French and foreign financial institutions that are active in the Paris financial markets (persons interviewed listed in Appendix 1). They agreed to submit their viewpoints on the questions they were asked (list in Appendix 3). Those viewpoints are included in this opinion.

The lawyers interviewed stated, and requested that this report indicate that their responses were made subject to the uncertainties persisting as to the terms of Brexit and the scope of any requirement to clear trades in the EU. They pointed out, for example, that if a requirement to clear trades in the EU applies only to institutions established in the Union, these institutions may be disadvantaged by such a requirement if their foreign competitors concluding similar transactions, are able to offer their clients more favourable trading terms that apply lower clearing costs outside the EU. Therefore, they deemed it necessary that the scenarios under consideration by the European authorities be clarified quickly.

The persons interviewed also requested that, to the extent possible given time constraints, the Banque de France, in connection with its consultations, schedule a meeting with all market operators and lawyers. It was also agreed that this report would include that request.

The responses herein to the issues raised by the Banque de France cover only legal matters, and do not discuss the economic, financial or political aspects of this complex matter.

At the conclusion of its work, the working group submitted its proposed responses to the HCJP at its plenary meeting of 27 March 2017.

A summary of the working group's recommendations is provided at the beginning of this opinion.

The HCJP approved the opinion prepared by the working group during its plenary meeting of 27 March 2017.

1 - Management of the transitional phase

1.1 - Issue one: From a legal standpoint, to what extent is a transfer of the positions of an offshore central counterparty to another central counterparty in the EU a corollary of a requirement to relocate clearing activities, if such requirement were adopted?

When they completed their work, the HCJP members concluded that transferring pending transactions is not a necessary corollary of a requirement to locate clearing activities in the EU, although such a transfer is feasible from a legal standpoint.

In theory, a requirement to relocate the clearing of interest rate derivatives denominated in EU currencies may take two main alternative forms.[20]

- Firstly, a requirement to clear transactions within the EU could be imposed for <u>all</u> euro-denominated interest rate derivatives (whether new or existing) as from a specific date, or it could be phased in gradually in accordance with an implementation schedule based on criteria to be defined (for example, types of counterparts, type of contracts and/or transaction maturity dates, etc.). If the European authorities adopt a clearing requirement substantially along these lines, regardless of its effective date, market operators would be required to transfer all of their existing positions cleared in an offshore CCP to one or more QCCPs in the EU.

Upon completion of such transfers, all interest rate derivative transactions subject to this requirement would be governed by the same clearing rules applicable to all QCCPs in the Union subject to EMIR and would be adequately supervised by the EU regulators. As discussed in section 1.3 below, legally there are two ways to transfer "open" derivative positions from one CCP to another.

- Alternatively, the requirement to clear transactions within the EU could be imposed only on new transactions concluded after a certain date, or a series of dates staggered over time on the basis of the same criteria discussed above. The law could include a grandfather clause that, despite Brexit, would give market participants the time to make arrangements and allow them to maintain pending transactions, either definitively (*i.e.* until their maturity) or for a certain period, with CCPs where they are currently validly cleared. A transfer of these positions to a QCCP in the EU would therefore not be mandatory.

[20] *The working group deemed that the two options described below are those most likely to be considered by European authorities. However, it cannot be excluded that other options may be considered during the Brexit negotiations.*

Obviously, under this approach, two different legal regimes applicable to the clearing of interest rate derivatives denominated in EU currencies would coexist. Transactions pending on the effective date of the rule would continue to be cleared in an offshore CCP until their maturity or liquidation. In contrast, all transactions concluded after the effective date of the requirement would be required to be cleared in a QCCP in the Union.

The HCJP did not identify any legal problem due to this coexistence of two clearing regimes for the same class of financial instruments, depending on the date the contract is entered into.

The gradual maturing of existing transactions will automatically reduce the portfolio of transactions cleared outside the Union. An objection may be made that, in the case of long-term transactions,[21] this situation could continue for a very long time. However, due to the factual context, the HCJP members do not believe this situation would last. This is due to the fact that market participants have a strong incentive to group as many of their transactions as possible with the same CCP. By setting off the negative values of certain contracts against the positive values of others, net collateral requirements are necessarily reduced by concentrating transactions within the same CCP. Therefore, it is expected that in the more or less near future, depending on their new activities, each market participant will reach a point at which it becomes uneconomic to maintain separate clearing books with two CCPs for the same asset class, despite the cost of transferring positions to the new CCP.

1.2 - Issue two: Are there legal considerations that would justify compelling positions cleared to be transferred if a requirement to relocate clearing transactions is adopted?

Setting aside the sovereignty and liquidity risk management issues raised above, the HCJP members have concluded that, broadly speaking, two legal considerations arise, depending on whether the issue is viewed from the point of view of the regulator or of users, *i.e.* depending on factors of (i) supervision or (ii) equivalence recognition and prudential treatment.

- ***Supervision factors.*** A review of this issue is complicated by the terms of Brexit still being unclear. This report will focus solely on the current law.

At this time, an entity established in a Member State can provide clearing services only if it is authorised and supervised in the EU. QCCPs in the Union are authorised and supervised by

[21] *The term of certain contracts may exceed ten years.*

national authorities. In France, the *Autorité de contrôle prudentiel et de résolution* ("ACPR" - Prudential Supervision and Resolution Authority), the *Autorité des marchés financiers* ("AMF" - Financial Markets Authority) and the *Banque de France* perform these duties. In the United Kingdom, the Bank of England is the competent regulator.

Furthermore, a general system of co-operation between national regulators for supervising QCCPs in the Union is currently in place in the EU, particularly via ESMA. In particular, EMIR mandates the creation of supervision colleges comprising several national regulators who provide an opinion on whether authorisation should be granted to CCPs in each EU Member State.[22] Regulatory technical standards have been adopted that govern the functioning of these colleges.[23] Lastly, EMIR requires the regulators of each Member State to co-operate with ESMA on the supervision of QCCPs.[23]

In the event of a "hard" Brexit, *i.e.* without any agreement between the United Kingdom and the EU, it is difficult to see how these forms of co-operation could be maintained. However, CCPs are a source of systemic risk for our economies, which justifies the constraints imposed by their supervision regime and the extent of these controls. Unless the British CCPs voluntarily submit to this supervision (assuming they can and are not prevented from doing so by a law such as a "blocking statute"), EU regulators will not only cease to have any supervisory authority over British CCPs, but they will lose all access to information about the exact nature, precise content and size of the financial flows they clear, despite their systemic implications for the EU.

- ***Equivalence recognition and prudential treatment factors.*** Considered from the viewpoint of users, analysis of this issue also requires beginning with a discussion of the current law.

In the event of an "uncoordinated" Brexit, it is not unreasonable to suppose that all British CCPs will lose their QCCP status, at least temporarily, while the United Kingdom requests and obtains an equivalence determination from the European Commission and then ESMA individually recognises each CCP. In the meantime, all EU institutions subject to the EMIR and CRR regulations will face significant risk because all transactions cleared in the United Kingdom will cease (i) to be in compliance with the requirements of EMIR, and (ii) to be entitled to the considerably less onerous capital requirements that apply solely to the treatment of exposures to QCCPs. This will lead essentially to two types of impacts.

Non-compliant institutions will risk penalties for violating the clearing obligation and will have to satisfy higher capital requirements.

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[22] *Articles 17 and 19 of EMIR.*

[23] *Commission Delegated Regulation (EU) No. 876/2013 of 28 May 2013 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on colleges for central counterparties.*

However, the prudential impact could be mitigated if the “transitional” regime of Article 497 of the CRR described above, which entitles offshore CCPs to be treated as QCCPs for CRR purposes, is extended once again.

1.3 - Issue three: Are there legal impediments that would prevent such inter-CCP transfers from London to Paris?

Subject to the issue of the membership rules for French CCPs,[24] the HCJP did not identify any major legal impediment that would, in theory, prevent a transfer of existing positions from a London CCP to a Paris CCP.

There are only two ways to transfer an “open” derivative position from one CCP to another. The specificity of derivative financial instruments is that they are continuous performance bilateral contracts involving mutual payments or regular exchanges between the two counterparties, over terms that are often very long.[25]

1.3.1 - Firstly, the contracts may be assigned. French law recognises this concept of a combined transfer of rights and obligations.

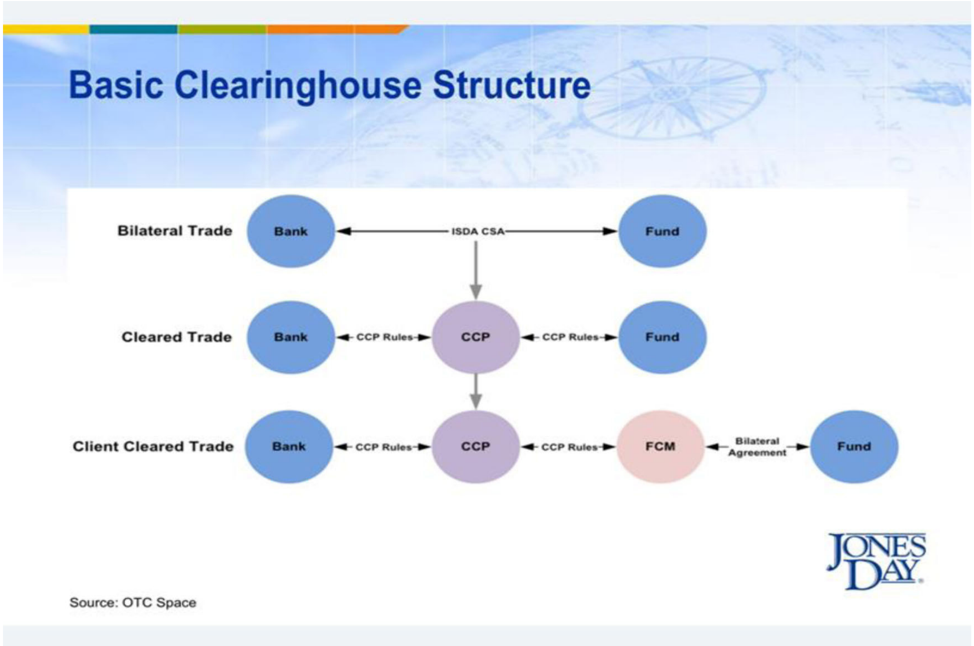
On this issue, the HCJP focused on identifying what would be the key stages in implementing such a transfer and the legal difficulties associated therewith.

There is no known precedent for a proposed transfer of this magnitude. The experience of the HCJP members, and the work of certain members on similar projects designed for market operators, lead the HCJP to estimate at two years, at least, the time required to complete such operation, assuming the full co-operation of all parties involved. A description of the main stages of a transfer of this type is provided below.

1/ Mapping memberships. It is not possible to conceive of transferring derivative transactions from one CCP to another unless both CCPs – the transferor of the financial flows, as well as the transferee – have the same clearing members or, at least, broadly overlapping memberships (indirect clearing is theoretically possible, although financially less attractive). This constraint is best shown by the diagram below:

[24] *On this point, see the response to issue four below.*

[25] *In practice, contracts may be entered into for very long terms (ten years or more).*



Except in the unusual situation of derivative transactions negotiated on organised markets, interest rate derivative contracts, at the outset, are most often negotiated bilaterally over the counter, *i.e.* between two counterparties who freely set the terms and conditions of their contracts. If the transaction meets certain criteria (in relation to its underlying, standardisation, liquidity, etc.), European law requires for it to be submitted, nearly immediately after its conclusion, to a CCP for admission to clearing. If no CCP accepts the transaction – and they have full discretion to accept or refuse trades – the transaction must be terminated, and European law prohibits that it be continued in bilateral OTC form. However, if a CCP accepts a formerly bilateral derivative transaction for clearing, the transaction will be novated to the CCP. As a result, the CCP will become the intermediary between the two original counterparties, thereby becoming the buyer's seller and the seller's buyer. Applied to interest rate derivatives, the CCP will become the payer of the floating rate for the counterparty that pays the fixed rate, and the payer of the fixed rate for the counterparty that pays the floating rate. When novated to the CCP, the original transaction disappears.

Depending on whether the original counterparties to the transaction are members of the CCP that accepts the trade (which is often the case for contracts between the largest banks, for example), they will either become direct counterparties of the CCP or will have to use the services of another entity that is a clearing member of that CCP (that entity is referred to as an "FCM", for "futures commission merchant", in the diagram above), which, for a fee, will perform the necessary formalities for the trade to be cleared by the CCP.

As the foregoing discussion shows, a CCP can clear interest rate derivatives only if there are two parties, one paying a fixed rate and the other a floating rate, with the CCP acting as an intermediary between them. Therefore, for a transaction to be transferred from one CCP to another, both parties and their respective clearing members, as applicable, must each be members of both CCPs in order to transfer and accept the transaction.

However, the membership requirements for CCPs in France are more restrictive than those for CCPs in Germany and the Netherlands.

In Germany, no conditions are imposed by law, and each CCP has the primary responsibility for setting its membership requirements. This is true, for example, in the case of Eurex, which offers interest rate derivative clearing services in the EU. Eurex has different classes of members, depending on the trades cleared and the risks transferred to the CCP. In particular, it admits insurance and reinsurance companies and UCITS and other investment funds as direct members.

In the Netherlands, the law specifies only that membership criteria should be clear, objective and known to all parties.

Due to the more restrictive requirements imposed by French law, it may be much more difficult to transfer trades from a CCP in the United Kingdom to France, rather than to Germany or the Netherlands. The HCJP considers that this is a first legal impediment to be dealt with.

It may be contended that this obstacle is not insurmountable. It is true that it is conceivable that a clearing member of a British transferor CCP that is not and cannot become a member of a French transferee CCP may use the services of an FCM that is a member of that CCP to accept its trades. However, this disregards the complexity involved in negotiating clearing agreements between FCMs and their clients. Therefore, if this requirement is adopted, the HCJP members deem it indispensable for France to embark, at the same time, on a project to relax the membership requirements of French CCPs.

2/ After the issue of memberships has been dealt with, the transfer will then require ***submitting the necessary reports and obtaining the required regulatory authorisations*** from all relevant supervisory authorities. Launching a new clearing service for a new asset class by a French CCP will require drafting a new rule book, which will have to be approved by its college of supervisors. It is difficult to envision this approval process being completed in less than six to nine months, after the rule book has been drafted in its entirety and the service offer has been finalised. In the case of interest rate derivatives, it will be necessary for CCPs to acquire risk management and valuation tools for these new instruments. They will also be required to secure the admission to its platform of the main market dealers.

As is the case for LCH SA's CDS service, these dealers provide liquidity and ensure the pertinence of prices and the solidity of the position liquidation mechanisms under ordinary circumstances and in the event of the default of a CCP member.

3/ Thereafter, individual discussions should be initiated with the clearing members and the institutions subject to the new requirement and the necessary adjustments to all contractual documents between them and the CCPs or their FCM should be made, in order to ensure the terms and conditions of these contracts, including with respect to the collateral for trades, are suitable for the new risks created by the transfer of these transactions. Although, in principle, CCP membership agreements are not negotiated and are de facto virtual standards, the technical complexity and timeline of this stage should not be underestimated.

4/ Subsequently, ***a migration plan*** describing, in detail, all stages of the concrete process for the transfers and the contracts to be concluded by both CCPs and the members concerned by the transfers of contracts and debts. French law provides specific legal instruments for derivatives in Article L.211-36 et seq. of the *Code monétaire et financier* (Monetary and Financial Code), which, in the domestic sphere, could be used for these transfers. However, under English law, it is impossible to assign debts and, therefore, two simultaneous novations will be required to transfer a derivative transaction. As stated above, when an OTC derivative is accepted for clearing by a CCP, it disappears and two new transactions arise: (i) one between the counterparty that pays the fixed rate and the CCP, and (ii) another between the counterparty that pays the floating rate and that same CCP. Therefore, in order to substitute a different CCP for the original CCP, a novation will be required not only for the first leg of the trade, but also for the second. No CCP would agree to being assigned only one of the legs of the transaction because this would mean that it would be obliged to pay a fixed rate to one of its members, without having the assurance that it would simultaneously receive such fixed rate from another of its members. These two novations, which should not be confused with the initial novation pursuant to which the trades are transferred to the CCP, will require concluding, necessarily simultaneously, two new three-party novation agreements between the CCP members and the CCP. These contracts will have to cover both the members' financial obligations under the trades themselves, as well as their collateral obligations in relation to said trades pursuant to the relevant CCP's rule book. Because the collateral requirements of CCPs are not identical, it is possible that the transfers will involve significant adjustments to the collateral already deposited. These contracts should be standardised, and the processes for entering into them should be systematised.

Undoubtedly, these four stages may, at least in part, be carried out in masked time. However, they must all be completed before the migration itself may begin. The time necessary to carry out the four first stages is estimated at one year.

5/ The migration itself may begin with successive ***testing*** phases on a sample of transactions. The tests should also be performed on collateral transfers.

6/ When the testing phase is completed and has been approved by the regulator, and all contractual documentation is in place, the ***positions may be transferred.***

The HCJP has found that, although positions have been transferred from one CCP to another in the past, such transfers have always occurred in the specific context of a merger and takeover of a CCP by another CCP. Consequently, the new issues that the HCJP working group deals with in this report, were never raised because in these previous cases the transfers were made by a universal transfer of assets. This does not necessarily mean that the regulatory stages were simplified or shortened, but they did not raise the issues of memberships, entering into novation contracts, or collateral transfers. In these previous cases, by definition, all parties were acting in concert and all clearing books (and not only certain trades) were transferred. Moreover, the transfers concerned derivatives traded on financial markets and not OTC contracts.[26] In addition, the volumes involved were significantly lower than those of the interest rate derivative market, which is the asset class with the highest volume of outstandings of all financial markets, including credits. Lastly, a transfer by novation as described above requires a voluntary three-party contract. This means that the transferor CCP must consent to these and, more generally, fully co-operate at all stages of the migration.[27]

1.3.2 - Alternatively, pending transactions will have to be liquidated and concluded simultaneously (or in very rapid sequence to avoid any change in mark-to-market values).

Concretely, this would require (i) liquidating the original contract within the first CCP, and (ii) entering into a new identical contract admitted to clearing with a new CCP.

[26] *For an overview of these precedents, see the report entitled "CCPs post-Brexit - Implications for the users of financial markets in the UK and EU27", IRSG op. cit., p. 8.*

[27] *Which is conceivable if LCH SA remains a subsidiary of the LSEG group.*

1/ In theory, ***the original trade can be liquidated*** by entering into a symmetrical transaction *(i.e.* a transaction in the opposite direction). The payer of the fixed rate agrees to enter into a new contract under which it will pay the floating rate, and the payer of the floating rate agrees to act as the counterparty for this new trade and pay the fixed rate. If this new contract is entered into between the same two counterparties in OTC form, when novated within the original offshore CCP, these financial flows are set off, thereby in practice extinguishing the first trade and reducing the collateral required. From a legal viewpoint, unless the portfolio is "compressed" by the offshore CCP, there are two separate transactions. However, from an economic standpoint, there are no more financial flows.

2/ If at the same time the original contract is liquidated within the first CCP, the same two counterparties enter into a ***new OTC contract*** with identical terms to those of their original contract, and if they submit this new trade to a QCCP that accepts it, they will in the end be parties to an identical interest rate swap but one that has been novated to a QCCP located and supervised in the EU.

This solution will require reaching a line-by-line agreement with all of the original counterparties in order to enter into new symmetrical liquidation transactions, identify the clearing members in the new QCCP and mobilise the financial flows necessary to carry out the transactions.

1.3.3 - ***The specific issue of collateral.*** As the Banque de France points out in its assignment memorandum, regardless of their form, these transfers will require, at least temporarily, double collateral for market participants' positions due to the fact that the time required to transfer the collateral will be longer than the time required to transfer the positions themselves.

The collateral deposited with the transferor CCP in relation to existing positions will not be able to be immediately transferred to the transferee QCCP due to the time constraints associated with margin transfers, and it will be necessary for market participants to deposit the collateral required to clear their trades already transferred or concluded with the QCCP pursuant to its operating rules.

The HCJP has studied two possibilities or courses of action to overcome this difficulty. These consist of two alternative mechanisms: (i) a system similar to the correspondent central banking model, and (ii) a trust (*fiducie*).

1/ Setting up a system equivalent to the correspondent central banking model. The aim of this system would be to entitle transferee CCPs of existing positions to be validly covered by collateral deposited with the transferor CCP, through a mechanism similar to the correspondent central banking model (CCBM).[28] The transferee CCP would not be required to request that market participants deposit collateral, which would avoid the double collateral issue raised above. The collateral on deposit with the transferor CCP would then be gradually transferred to the transferee CCP.

However, after reflection, the HCJP members have identified serious impediments that preclude setting up such system. The main one is the fact that EMIR does not allow QCCPs to accept trades for clearing for which they do not themselves hold the collateral.[29] Consequently, setting up a system equivalent to the CCBM for holding collateral requires amending EMIR. Such amendment is further complicated by the fact that this would result in the collateral of an EU QCCP being held by an offshore CCP over which, by definition, there would be limited supervision. On a purely practical level, the time necessary for such an amendment to EMIR to take effect seems inconsistent with the forecast Brexit timeline and the periods necessary to set up a mechanism for relocating interest rate derivatives positions to the Union.

Moreover, the HCJP concluded that if the transferor CCP retained the collateral, given the systemic nature of the amounts in question, the European authorities would certainly require that margin calls be calculated and collateral be managed in accordance with EMIR. Yet, because after Brexit takes effect such CCPs would cease to be a QCCP,[30] their compliance would be voluntary only and would probably require an MoU[31] with the European supervisory authorities in which commitments would be made at least during a transitional period. All of which adds up to a number of quite uncertain factors in the current context.

2/ Setting up a trust structure. The HCJP also considered the possibility of setting up a trust. Implementing the idea would require two stages: (i) transferring the collateral held by an offshore CCP to a trust in which an EU QCCP would be the trustee and, initially, the offshore

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[28] The CCBM sets out the conditions under which the national central banks of the euro zone, in coordination with the European Central Bank, have set up a mechanism for creating eligible security for Eurosystem credit operations based on collateral held by one European national central bank (NCB) on behalf of another NCB, which can be used to finance a Eurosystem counterparty (for example, a commercial bank) established within the jurisdiction of that other NCB. This mechanism was set up to facilitate the access of Eurosystem counterparties to refinancing operations.
The CCBM is described in an ECB document of January 2017 entitled "Correspondent central banking model (CCBM), Procedures for Eurosystem counterparties", http://www.ecb.europa.eu/pub/pdf/other/ccbmprocedureseurosystemcounterparties201701.en.pdf.

[29] In particular, Article 41 of EMIR provides that QCCPs must call, collect and manage margins.

[30] The working group assumed that the transfers could be carried out only post-Brexit given the time that would be required to set up these transfers.

[31] Memorandum of Understanding.

CCP would be the sole beneficiary; then (ii) at the time of the transfer or when new contracts are entered into, changing the beneficiary and making the EU QCCP the beneficiary of the collateral.

The advantage of this structure is that it would enable the offshore CCP and the EU QCCP to define by contract, with a great deal of flexibility and a minimum of formalities, the beneficiary of the trust, depending on the schedule for transferring the positions, with the beneficiary at all times being whichever CCP clears the collateralised trades.

From the viewpoint of members and users, this mechanism is admittedly not neutral because the benefits of the setoffs against their other trades cleared by the offshore CCP would be lost (although it can be assumed that if they have other trades cleared by the EU QCCP, this impact may be partially reduced) and the QCCP's collateral requirements may be stricter than those of the offshore CCP. Nevertheless, it avoids the double collateral risk discussed above because the flexibility of the trust and the procedure for changing its beneficiary allow the collateral to be transferred at the same rate as the trades for which it was deposited.

That said, the HCJP members have concluded that the same impediments as those identified for setting up a system equivalent to the correspondent central banking model apply to the trust, which, based on current positive law, seems inconsistent with the EMIR requirements that QCCPs hold collateral and, in any event, would also require contractual agreements.

1.4 - Issue four: Are there legal impediments that could prevent clearing members currently active in London CCPs from becoming members of French CCPs?

The HCJP has found that, after Brexit, the statutes and regulations governing membership of clearing members in a French CCP could prevent active clearing members of LCH Limited from becoming clearing members of French CCPs. Although this observation was already made earlier, the reasons therefor will be set out in detail below.

Article L.440-1 of the *Code monétaire et financier* contains an exhaustive list of the entities authorised to become members of French CCPs. These are primarily credit institutions and investment firms that have their registered office in France, that do business in France under a European passport, or whose registered office or effective management is located in a Member State of the EU or of the European Economic Area.

However, the membership of credit institutions and investment firms that have their registered office in a non-Member State of the European Economic Area, as well as of legal entities whose primary or sole purpose is clearing financial instruments and that are not established in mainland or overseas France requires the prior authorisation of the AMF. The AMF will ensure that the organisations in question are subject to rules in their home States governing the right to engage in the clearing business and controls that are equivalent to those in effect in France. The AMF must also enter into information exchange agreements with the competent authorities of the home State.[32]

Pursuant to these statutes and regulations, British credit institutions and investment firms that are currently clearing members of LCH Limited and that clear interest rate derivatives denominated in EU currencies, would be required to obtain the prior authorisation of the AMF in order to become clearing members of a French CCP after Brexit. A specific co operation agreement would also have to be concluded between the AMF and the British authorities.

Consequently, British investment firms and credit institutions that are currently clearing members of a British CCP and clear existing positions in interest rate derivatives denominated in EU currencies, and who do not have a branch or subsidiary in the European Economic Area, must obtain AMF authorisation to continue to engage in this activity in Paris in the event these positions are transferred after Brexit. At the least, the authorisation procedure and the negotiation of an agreement between the French and British authorities will take time and is likely to delay the transfers of existing positions if such transfers are required by European law.

Moreover, the HCJP points out that a detailed analysis of the contractual membership rules contained in the LCH SA clearing rules and the LCH Limited rule book should be conducted to determine if the LCH SA membership criteria (minimum capital, internal organisation, information and audit obligations, etc.) include impediments that would prevent an entity that is a valid clearing member of LCH Limited from becoming an LCH SA clearing member.

In view of these factors, the HCJP recommends that the legal requirements for membership in French CCPs be unilaterally relaxed, under the control of the Banque de France and the AMF, in order to more easily authorise institutions located outside the EU and European Economic Area to become clearing members of French CCPs. This measure may be adopted at the domestic level alone.

In conclusion, the HCJP considers that particular attention should be paid to the subject of the membership rules for clearing members so as to not hinder the development of a new interest rate derivatives clearing market in Paris. The HCJP has already noted that these

[32] *Articles 541-16 and 541-17 of the General Regulation of the Autorité des marchés financiers.*

conditions are less restrictive in other European financial markets, which could take advantage of that regulatory competitiveness edge to attract the financial flows currently located in London.

This observation applies regardless of whether the relocation requirement includes a grandfather clause.

1.5 - Issue five: Are there any tax impediments to the transfer of clearing members' positions?

The answer to this question is complex because the tax consequences of a transfer may vary depending on the legal status and home State of the parties. Therefore, it was not possible to consider this issue in detail within the time allotted to the HCJP to submit its opinion. However, based on its preliminary analysis, the HCJP concludes that this risk cannot be excluded. Therefore, it has been agreed with the Banque de France to defer the study of this issue and to include British tax experts in the project.

The *Fédération bancaire française* ("FBF" - French Banking Federation), which took part in the work of the HCJP group, has suggested that the following issues be examined in greater detail in connection with such project:

(i) For corporation tax purposes, can the transfer be considered to be the disposal of a business line or business?

(ii) What would be the value of the transactions? What would be the consequences of such valuations for banks, in particular if there is a novation?

(iii) For VAT purposes, the consequences will differ depending on whether the United Kingdom is still or is not an EU member at the time of the transfer. How would the disposal of the portfolio be classified?

A memorandum prepared by the FBF, setting out a preliminary analysis on the accounting and tax treatment currently applicable to interest rate transactions in France for credit institutions and investment firms, is appended to this opinion (Appendix 5).

1.6 - Issue six: Does French law contain specific problematic provisions that could hinder a transfer to the Paris financial markets (especially if such impediments do not exist in other European laws, in particular the German and Dutch laws)?

Other than the issue of the membership requirements for French CCPs discussed above, the HCJP did not identify specific problems in French law that would hinder transfers of open positions.

The obstacles due to the provisions of EMIR and the CRR would be the same for Germany and the Netherlands, because the regulations are of direct application in those countries as they are in France.

The contractual implementation difficulties would appear to be the same in Germany and the Netherlands. However, on this issue, it bears noting that in England and the Netherlands there are mechanisms that permit, without obtaining the counterparties' individual agreements, transfers that have the same effects as a universal transfer of assets, but without covering an independent business division. These mechanisms, which are called FISMA Part 7 Schemes in England, are carried out under the sole supervision of a court, which approves the carve-out of the assets and liabilities transferred. Dutch law has a nearly equivalent procedure. However, their implementation in cross-border contexts is extremely complex – learned commentary in France is divided as to the extraterritorial effects of such arrangements - and their application requirements are very restrictive – in principle, limited to credit institutions, which in France is the case of LCH SA but not of British CCPs. This issue alone deserves a comparative law study that the HCJP was unable to provide.

1.7 - Issue seven: Other matters that the HCJP deemed opportune to study with respect to the transitional phase in the context of developing an interest rate derivative service in Paris.

During the course of its work, the Banque de France submitted an additional issue to the HCJP.

When Brexit takes effect and British CCPs lose their QCCP status, what will be the legal capacity of European clearing members of such CCP to take part in auctions in the event of a default of one of its members? In a crisis scenario, these auctions are used to redistribute the positions of a defaulting member of a QCCP to other members of that QCCP. These auctions can be carried out only if there is a minimum number of bidders.

Due to a lack of time to focus on this issue, it was also agreed to consider this issue at a later time without delaying the production of this opinion.

Otherwise, the HCJP did not identify any other issues to be examined at this stage.

2 - Use of French law in the derivative markets

2.1 - Issue one: What benefits would be derived from making interest rate derivative master agreements subject to French law?

When a derivative transaction originally entered into in OTC form is accepted for clearing by a CCP, the transfer is carried out, as described above, by novating the trade to the CCP. This novation creates two new legal relationships, with the CCP becoming an intermediary between the original counterparties. The original OTC trade disappears. When novated to the CCP, the trade ceases to be governed by the terms of the master agreement that governed it until then, and will be governed solely by the provisions of the rule book of the relevant CCP and the laws of the country in which such CCP is located. Therefore, in agreement with the Banque de France, the HCJP studied the matter of whether the law applicable to OTC master agreements, and the use of French law in these financial market agreements, are essential issues. Our work focused on the use of French law by the CCPs and, more specifically, by the CCPs in France that may provide the interest rate derivatives clearing services on which this opinion concentrates.

Aware that the use of English law is preeminent due to the current importance of the London financial markets in clearing derivatives trades, the HCJP working group first examined how LCH SA organised its credit default swap (CDS) clearing service. It is undisputed that this service offer is a success and that market participants have taken advantage of it. Nevertheless, at the time this service was created, the issue of what law should apply to these trades post-novation was the subject of significant discussion and work, which must be briefly reviewed in order (i) to understand the balance achieved to the satisfaction of the market, and (ii) to consider whether such balance is altered (a) by Brexit and (b) in the case of interest rate transactions.

<u>Appendix 3</u> to this opinion provides a detailed description of the law applicable to CDS clearing using LCH SA's CDSClear service.

In sum, this service is based on a legal technique under international law that allows dual attachment, *i.e.* attaching two clearly separable sub-components of the same contract to two different legal regimes. For the purposes of LCH SA's CDS service, this dual attachment means that the CCP's general operating rules (membership, management of accounts and positions, management of margin calls, management of defaults, etc.) are governed by French law, whereas the obligations arising from the trades themselves are governed by English law.

The HCJP working group focused on the reasons for this choice. During the course of its interviews, it identified two main reasons:

- Firstly, it was informed that it was important for international banks and, in particular, for their risk departments, that the trades be governed by English law to avoid fragmenting the management of legal risks. English law dominates the clearing of derivatives. Banks have solid legal opinions on the validity and enforceability vis-à-vis third parties, including in the event of default, of rule book provisions on netting, collateral and transferability of positions in the event of a member's default. From an organisational standpoint, it is efficient to pool the value of these opinions. Furthermore, English law has a reputation for quality, respect for contractual provisions and favour to business interests, which, together with the reputation for quality and financial expertise of the English courts, promote its widespread use in the markets.

- It was then noted - and this argument carried the day - that CDS, unlike other derivatives, are very specific in nature. Their payment profiles are not governed by a change in the value of a specific underlying. Of course, certain credit derivatives, such as total return swaps or credit spreads, are based on such values, in this case the credit spread between one or more underlying legal entities. However, this is not the case for CDS. The words are deceptive, and a credit default swap is in fact a type of option. In consideration for the payment of a premium, one of the counterparties to the trade buys credit protection against the default of one or more third parties, known as the "reference entity(ies)". Its counterparty undertakes to make it a payment, agreed on the basis of terms that vary, if any of the following three legal events occurs: (i) a payment default by the reference entity, (ii) its insolvency, broadly speaking, and (iii) the restructuring of any of its debts. Therefore, what triggers a payment obligation under a CDS is not a statistical variable, the price of an asset, the level of an interest rate or currency or an objective and observable measure, but concepts that are primarily legal: payment default, insolvency and restructuring. The issues of the intellectual content and classification thereof, and the case-law and learned commentary that develops based thereon, are essential to the market because these instruments are valued on the basis of these concepts and their interpretation. The stability, uniformity and foreseeability of their interpretation are key prerequisites. The OTC CDS market is dominated by the use of market documentation published by the International Swaps and Derivatives Association (**"ISDA"**) that is governed by English law or the law of the State of New York. In the late 1990s, there were several attempts in Germany and France to develop localised documents for these transactions, but they were not successful. Concretely, this means that CDS contracts are entered into and valued solely under English law or the law of the State of New York, and on the basis of the definitions of these concepts under these laws (incidentally, the definitions under these laws are not identical and the English and US CDS markets are not fungible).

Based on these circumstances, it would have been problematic for LCH SA in Paris to ignore these factors and offer the market a model that post-novation would subject ISDA CDS contracts originally entered into under English or New York law to French law. The transactions themselves and their market price would have been intrinsically modified.

However, in the opinion of the HCJP working group members, matters have changed and the characteristic of the CDS markets described above does not apply to interest rate derivatives. The payment profile of interest rate derivatives is not defined on the basis of legal concepts. Therefore, the HCJP working group focused on the issue of whether, for these transactions, and in the context of Brexit, the reasons that were the basis for the choice of LCH SA for CDS are currently relevant for interest rate derivatives. The members of the working group are not persuaded that they are.

Consistently with the work previously conducted by the HCJP and the conclusions of its *Report on the implications of Brexit on judicial co-operation in civil and commercial matters*, which was published on 30 January 2017, it was noted that Brexit risks profoundly modifying the effect of British court decisions within the EU. Without a transitional agreement, the decisions rendered by the courts of the United Kingdom will no longer be entitled to automatic recognition in the EU (this point is discussed below in the third section of this opinion). However, in practice, the court granted jurisdiction and the governing law are matters that are very closely tied. Based on the reasonable assumption that parties will less frequently designate the British courts as the courts with jurisdiction to resolve their disputes if one of the parties is located in the EU, it should follow that the English law will be chosen less often as the law governing such contracts. The argument concerning the fragmentation of risk analyses should logically lose importance.

It has not escaped the HCJP that the London financial markets are aware of this danger and are currently taking various initiatives to get round this difficulty. The most significant is to promote the creation of an international instrument, under the aegis of the Hague Convention, which would provide for immediate mutual recognition of court decisions of signatory States.

Moreover, the HCJP takes note that since the end of the 1990s, the French law applicable to financial transactions, in particular the special law of derivatives, has made immense progress. On numerous occasions, the courts have approved the solutions implemented by Article L.211-36 et seq. of the *Code monétaire et financier* on netting and financial guarantees. French law expressly approves global netting agreements. In addition, pursuant to the most recent improvements to the law, opportunely made by the *Loi Sapin 2* in December 2016, French law recognises agency clearing models (as opposed to the principal to principal model) that are used by some of the largest CCPs in the world, in a manner and with a certainty that are without equivalent in any other jurisdiction worldwide, making French law one of the most advanced and robust laws – including compared to English law that provides no solid solutions on this issue. The recent reform of the law of contracts should also make French law more attractive.

On these bases, the members of the HCJP working group deem, and the legal departments interviewed have confirmed, that institutions that use French law for their OTC trades and the services of a French CCP to clear their derivative trades, will have solid legal opinions that are consistent with market practices.

It should also be noted that the application of French law after the novation to the CCP will not impose any identified cost or reorganisation obligation on market operators. Because the original OTC transaction will cease to exist at the time of the novation, there will be no need to retrain in French law the teams that negotiate the ISDA master agreements. If institutions wish to continue to use the ISDA master agreement for their OTC trades, the fact that post-novation such trades will be governed by French law will not prevent them from doing so. For many years in the equity derivatives market, OTC ISDA trades in listed French underlyings have been hedged by positions concluded on the French futures markets, and this has not hindered the development of this market.

Lastly, if for some unlikely reason, the Paris financial markets failed to convince market operators of the competitiveness of French law, the dual attachment mechanism that LCH SA uses for CDSClear provides a useful precedent that could be applied to the proposed interest rate derivatives clearing service.

2.2 - Issue two: Is promoting the use of French law in these master agreements a strategic objective?

The issues of sovereignty and controlling systemic risk have already been discussed above.

The HCJP considers that promoting French law is a strategic endeavour, as well as a potentially significant source of growth for the country and of varied and numerous jobs in the financial sector.

Encouraging the use of French law, together with the ongoing modernisation of our courts, are two key components of any project to develop the Paris financial markets.

Because the choice of law applicable to transactions is very closely tied to the choice of courts with jurisdiction to resolve disputes in relation thereto, promoting the choice of French law should logically lead to stronger arguments in favour of choosing French courts. A cascade of effects will necessarily follow, because application of a particular law will require banks and financial institutions to hire in-house lawyers who specialise in that law. The universities and *grandes écoles* will then adjust their curricula to this demand and will contribute to attracting foreign students to France, thereby ensuring a long-term international dimension not only to the Paris financial markets, but also to the fundamental solutions offered by French law and European law. As the work of the World Bank on these issues has clearly shown, the solutions offered by a legal system, in fact, reflect a certain world view. The stakes are therefore considerable and exceed those, albeit important, of the economic interests of the Paris financial markets.

2.3 - Issue three: In the case of listed trades, what is the practice with respect to the use of French law?[33] Is it systematic or are there exceptions? What legal strategy should be promoted in this area?

Due to the time constraints imposed on it, the HCJP working group, which essentially comprised in-house counsel and barristers, felt that it did not have the statistical data, nor the resources to compile such data sufficiently quickly, to provide the Banque de France with a useful response. The HCJP proposes to study this issue at a later time if the Banque de France confirms its interest.

2.4 - Issue four: Is it realistic to promote the use of French law in the master agreements by French counterparties, as well as by European and international counterparties?

The HCJP concludes that this question can be answered in the affirmative. Brexit and the uncertainties it generates, and which are discussed above, created a favourable context that may lead to more frequent use of French law.

Except for the issue of the membership requirements for French QCCPs, which deserves urgent attention, compared to other European laws the HCJP has not identified any deficiencies in French law that would preclude it from becoming an alternative law.

It found that unlike most other European financial markets, French organisations, chief among them the FBF, whose efforts and work deserve particular recognition, have endeavoured over the past years to develop and maintain standard documents for all types of derivatives. For example, the FBF master agreement has been recently updated, as well as its tax appendix and its collateral documents. Its treatment of tax withholding on international transactions is evidence of the intent to make these instruments tools that are not limited to the domestic market. The HCJP has observed that most major international institutions are familiar with the FBF documents, consider that they are fully consistent with the highest international standards and use them quite frequently.

2.5 - Issue five: Is French law suitable for such use or does it have provisions that hinder its use internationally?

As stated above, except for the issue of the membership in French QCCPs, the HCJP has not identified any provision that could constitute a hindrance.

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[33] It should be noted that there are no longer any listed interest rate derivatives on the French market and examples thereof will be found primarily in Frankfurt. However, in Paris there are equity/indices and commodities derivatives that are cash-settled or settled by delivery for payment, as applicable.

2.6 - Issue six: What strategy might the Frankfurt financial markets adopt in this regard?

Due to the time constraints mentioned above, the HCJP was unfortunately unable to examine this significant issue and it has been agreed to defer the study thereof.

2.7 - Issue seven: What would be the advantages/disadvantages of offering a choice between the use of French law and English law, in particular to corporate clients?

The HCJP does not recommend this approach.

The traditional approach of French law and European law has been to limit the right of parties to freely decide on the law governing their contracts to transactions that present objective internationality factors. This "objective" theory has been long established in the case-law. The submissions of *Avocat Général* (Prosecutor) Matter raised the issue of "cross-border inflows and outflows". The HCJP does not believe that Brexit should lead to abandoning this approach and adopting a "subjective" view that would entitle parties to choose English law, including for domestic transactions.

2.8 - Issue eight: Other matters that the HCJP deemed opportune to study with respect to the use of French law for derivative transactions in the context of developing an interest rate derivatives service in Paris.

The HCJP did not identify any other issue to study concerning the use of French law for interest rate derivatives transactions.

3 - Advisability of requiring the use of the French courts to resolve disputes

3.1 - Issue one: To what extent is the jurisdiction of the French courts a strategic objective?

The HCJP working group studied the jurisdictional system of the courts and arbitration tribunals set up for CDSClear. Appendix 2 to this opinion provides a detailed description of the law applicable to the clearing of CDS using LCH SA's CDSClear service.

In sum, jurisdiction is granted to an arbitration tribunal in London for most disputes in connection with clearing operations carried out through CDSClear, and LCH SA has adopted a specific arbitration agreement for this purpose. In contrast, jurisdiction is granted to the French courts to resolve disputes in relation to the occurrence of a default by a clearing member or the CCP's general terms and conditions of operation. Provided the rules allow the arbitration tribunal to consider issues of French law, in general, the grant of jurisdiction is consistent with the applicable law. The two issues seem to be intrinsically linked.

The HCJP working group sought to understand the reasons for LCH SA's choices on these issues. During the interviews, it was informed that an English arbitration tribunal had been chosen due to international market operators' preference for English law and arbitration tribunals, deemed to be faster, more confidential and to have greater technical expertise. More generally, the interviews showed that market operators have a very high opinion of the British courts. This reputation has been established over many years.

However, based on separate work the HCJP has conducted on the impacts of Brexit on judicial co-operation, the HCJP believes that the preference of international operators for the London financial markets may change significantly in the future. We refer once again to the HCJP's report on these issues (*Report on the implications of Brexit on judicial co-operation in civil and commercial matters* - 30 January 2017), which covers these issues in detail. The report explains the reasons why judgments rendered by the British courts will no longer be entitled to automatic mutual recognition in the Member States of the EU under the current procedure of the Recast Brussels I Regulation. Consequently, when the United Kingdom leaves the EU, the decisions rendered by the British courts will be subject to the private international law exequatur procedures, which vary from one EU Member State to another.[34]

This new situation may make the British courts much less attractive for international firms. It is therefore possible that they may choose to relocate the handling of their disputes to an EU Member State.

[34] *See, in particular, p. 16 et seq. and p. 31 of the report.*

The HCJP considers that this new context offers an essential strategic opportunity for promoting Paris as a credible alternative to the United Kingdom as the jurisdiction of choice for resolving economic and financial disputes. It should lead to promoting the jurisdiction of the French courts and/or arbitration tribunals in cases involving disputes about the clearing of interest rate derivatives.

The HCJP concludes that, although the system LCH SA has adopted for CDSClear is useful and can be explained by the context of that time, after Brexit it should not be considered to be a precedent to be followed.

3.2 - Issue two: Are there impediments to requiring the jurisdiction of the courts in Paris over disputes concerning the clearing and trading of interest rate derivative contracts, in particular if such contracts continue to be governed by foreign law?

Two potential impediments may be envisaged: (i) the jurisdiction of the French courts to review foreign law contracts, and (ii) the language in which proceedings before the French courts may be conducted.

- On the jurisdictional issue, the HCJP believes that the fact that the interest rate derivatives master agreements or certain aspects of the clearing of these trades by a French CCP may be governed by a foreign law is not, in principle, an impediment preventing a French court from being designated to resolve disputes in connection therewith.

The French rules of private international law do not require that the court designated by the parties necessarily apply the law in effect in the country in which it is located. Therefore, in principle, the French courts may review foreign law contracts. In particular, the HCJP pointed out in the aforementioned report that a French court must apply English law if such law is designated as the law governing the contract it must examine pursuant to the rules laid down by the Rome I Regulation.[35]

Nevertheless, in that same report, the HCJP pointed out that the French courts are not preferred by the parties to a contract governed by English law entered into by major international firms due to the manner in which the French courts are believed to interpret contracts. Such operators tend to believe that the French courts do not apply contracts literally and may exercise a moderating power of interpretation that is unwelcome.[36] There is therefore a subjective impediment, due to the perception of the practices of the French courts when interpreting contracts, rather than a legal impediment in principle that would prevent a review of contracts governed by a foreign law and, more specifically, by English law.

[35] *Page 11 of the report.*

[36] *Page 35 of the report.*

Based on these circumstances, the aforementioned HCJP report recommends that specialised civil and commercial courts be set up in France, staffed with judges that have specific expertise in common law.

The HCJP reaffirms, in their entirety, those analyses and that conclusion.

- With respect to the language used in the proceedings, the HCJP noted that there are legal obstacles to the use of a foreign language for proceedings before the French courts due to domestic rules that enshrine the primacy of the French language.[37]

However, these obstacles may be managed by adapting certain French domestic procedural rules. Among these, the HCJP proposed in the aforementioned report that the use of English be authorised at various stages of French legal proceedings and that procedural rules inspired by the law of Anglo-American countries (discovery, cross-examination) be introduced into the domestic law.[38]

Moreover, one of the proposed requirements for qualifying court panels that render judgment would be their ability to judge disputes concerning clearing operations.

The HCJP also reaffirms, in their entirety, those analyses and that conclusion.

3.3 - Issue three: Apart from the case of CDS cleared in Paris, is there any precedent for such a provision?

Due to the time it was allotted to provide its opinion, the HCJP was unable to examine dispute resolution mechanisms other than those of CDSClear described above.

3.4 - Issue four: Should dual jurisdiction be considered, i.e. jurisdiction of both the courts in Paris and London? Why?

If the law applicable to interest rate derivatives trades is English law and if the law applicable to the CCP is French law, an argument can be made that jurisdiction should be allocated between the English and French courts in order to distribute disputes in a manner consistent with the applicable law. As explained above, that is the mechanism LCH SA has chosen for CDSClear.

[37] *The Cour de cassation (Court of Cassation) has held that "the Ordonnance of Villers-Cotterêts of 25 August 1539 is the basis for the primacy and exclusive use of French before the national courts" (Cass. Com. 13 December 2011, No. 10-26389).*

[38] *Page 34.*

However, because the HCJP's recommendations focus on the promotion of French law and its natural corollary, the jurisdiction of the French courts, the HCJP does not believe that, post-Brexit, this dual jurisdiction will be a system that should necessarily be promoted. Subject to the improvements to be made to the functioning of the French courts, as described in the previous responses, it seems entirely legitimate to defend the jurisdiction of the French courts over all disputes, including if English law is chosen to govern some of the trades cleared.

3.5 - Issue five: What strategy might Frankfurt pursue in this regard? What about Amsterdam?

In the aforementioned report, the HCJP noted that the Netherlands and Germany have already begun to adapt the operational rules of their courts in order to make them more attractive in the eyes of international firms. For example, the HCJP described how, since 1 January 2016, the Rotterdam District Court has experimented with the use of English in court proceedings that raise international law issues.[39] With respect to Germany, the HCJP explained that several German regional courts have created specialised chambers to deal with international commercial disputes, for which the use of English is authorised.[40]

Based on these precedents, the HCJP believes that it is foreseeable that the Netherlands and Germany will intensify their efforts to increase the attractiveness of their courts. Accordingly, the HCJP deems that if France delays in this area, its proposed interest rate derivatives clearing service will be less attractive than that of other EU countries that have court procedures that are more receptive to foreign firms.

3.6 - Issue six: What is the ability of the courts in Paris, Frankfurt and Amsterdam to analyse the English law contracts of CCPs? Do the courts in Paris face particular difficulties, in particular with respect to the use of English? If applicable, how can these impediments be overcome?

The matters raised by this issue have already been covered in the responses to issues two to five above.

3.7 - Issue seven: Other matters that the HCJP deemed opportune to study with respect to the use of the French courts in the context of developing an interest rate derivative service in Paris.

The HCJP did not identify any other issues to be studied in connection with the issue of using the French courts.

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[39] *Ibid.*
[40] *Ibid.*

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LIST OF APPENDICES

To consult on the website of the HCJP by downloading the document joined to the opinion: ANA08A-Appendices

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« The legal feasibility of developing an interest rate derivatives clearing service in Paris »

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