Haut Comité Juridique
de la Place financière de Paris

APPENDICES

*Of the 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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Composition of the working group

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APPENDIX 2

Memorandum on the CDSClear legal model

MEMORANDUM ON THE CDSCLEAR LEGAL MODEL

The legal model that LCH SA has set up to clear certain classes of credit derivatives (**CDSClear**) is an original legal model with respect to (1) the applicable law and (2) the dispute resolution procedure. This legal model is specific to the central clearing of credit derivatives by LCH SA through CDSClear. A complete and separate set of documents from those governing central clearing by LCH SA of other types of products has been prepared for CDSClear.

This memorandum has been drafted solely on the basis of public information available about the CDSClear clearing service offered by LCH SA.

1 - Governing law

1.1 English law has been granted a certain status in the clearing of credit derivatives by LCH SA, which is a French central counterparty, and which takes into account (i) the importance of English law in the credit derivatives market and (ii) the need for LCH SA to act as a central counterparty in accordance with the French law that applies to it.

1.2 The legal model set up within CDSClear is essentially based on an allocation between:

(a) French law, which governs the following documents that deal with CDSClear's "functional" aspect:

(i) the CDS Admission Agreement to be entered into between LCH SA and each clearing member;

(ii) the CDS Clearing Rule Book, which sets out general principles concerning the operation of LCH SA and the interpretation of the clearing rules, the admission of clearing members, clearing trades (registration of trades, novation and account structure), risk management (margin calls, collateral, managing the default of a clearing member and the default fund) and the specificities of client clearing;

(iii) all rules adopted by LCH SA pursuant to the CDS Clearing Rule Book detailing specifications, including the procedures set up by LCH SA concerning admission conditions, margin and collateral requirements, eligibility conditions for credit derivatives accepted for clearing by LCH SA, the operational functioning of clearing, the default fund, the continuity of LCH SA's clearing activities, disciplinary procedures set up by LCH SA and LCH SA's management of complaints;

(b) English law, which governs the following documents dealing with the CDSClear's "product" aspect:

(i) the CDS Clearing Supplement, which establishes the contractual framework applicable to credit derivatives cleared (terms and conditions, payment and delivery obligations, management of the occurrence of credit events, settlement of the transaction);

(ii) the ISDA Credit Derivatives Definitions, which are not quoted in full, but to which reference is made in the clearing rules;

(iii) Cleared Transactions, *i.e.* credit derivatives resulting from the central clearing by LCH SA and entered into by the clearing members and LCH SA; and

(c) English law has also been chosen to govern the document that deals with dispute resolution (the CDS Dispute Resolution Protocol) to be consistent with the choices made with respect to the dispute resolution procedure (see section 2 below).

1.3 Lastly, with respect to the applicable law, the legal model set up within CDSClear also provides for:

(a) the application of Belgian law to govern the pledge agreement that clearing members may use to satisfy certain of their obligations to LCH SA with respect to margins, other than by transferring full title to assets, if the accounts pledged are opened with Euroclear Bank; and

(b) the application of the law of the State of New York and the law of the United States to govern the FCM CDS Clearing Regulations ; this document incorporates into the LCH SA clearing rules all principles imposed by US law, in order to enable clearing members that have Futures Commission Merchant status (within the meaning of the US law) to be admitted to LCH SA to clear credit derivatives.

1.4 The contractual relationship between the clearing members and the central counterparty is thus "carved up", essentially on the basis of the dominant position of English law in the credit derivatives market. The "carving up" practice consists in submitting a single contractual relationship to various legal regimes; it is recognised by the legal doctrine. A certain number of precautions have been taken in order to reduce, to the extent possible, the risks generated by carving up the contractual relationship between the clearing members and LCH SA.

For these purposes:

(a) the content of the documents governed by a law other than French law has been reduced to the strict minimum;

(b) no ISDA master agreement, whose provisions may conflict with the provisions of the clearing rules subject to French law, has been entered into between the clearing members and LCH SA (except transactions concluded for hedging purposes in connection with management of defaults);

(c) a strict hierarchy has been established between the various documents laying down the clearing rules, in order to manage any residual risk of discrepancies between such documents and to ensure that, in the event of a conflict between various documents, the principles governing LCH SA's management of defaults by clearing members, and then the remaining provisions of the CDS Clearing Rule Book, will prevail over the provisions of other documents (except in the case of conflicts as to the existence and/or amount of payment and delivery obligations under cleared transactions, in which case the provisions of the documents governed by English law will prevail to the extent permitted by law).

2 - Dispute resolution procedure[1]

2.1 The central counterparty has chosen arbitration as the method for resolving disputes that may arise in connection with the clearing of credit derivatives by LCH SA, due to the generally recognised advantages of arbitration, in particular the flexibility that an arbitration tribunal offers in organising the dispute resolution procedure.

2.2 For this purpose, jurisdiction has been granted to an English arbitration tribunal, which is consistent with similar choices made by LCH SA's competitors, and which is not contraindicated or prohibited by any legal principle. Furthermore, the choice of the seat of arbitration has relatively limited consequences, which concern essentially the arbitration procedure and the conduct of the arbitration proceedings. Due to the "carve-up" described above, the composition of the arbitration tribunal should also ensure an appropriate representation of French and English law experts. In addition, it is recommended to include experts in central clearing and/or cleared products, to cover all issues that may arise in the course of the proceedings.

2.3 Despite the preference for arbitration as a dispute resolution method, we understand that the French courts may also have jurisdiction over certain aspects in connection with clearing by CDSClear.

[1] *The provisions on the dispute resolution procedure are set out in the CDS Dispute Resolution Protocol, which is not in the public domain*

2.4 Lastly, the clearing rules also include provisions in relation to (i) disciplinary procedures that LCH SA may initiate against clearing members that do not comply with the clearing rules, and (ii) LCH SA's management of complaints submitted to it by clearing members that contend that LCH SA has failed to act in accordance with the clearing rules, prior to initiating court or arbitration proceedings. Such procedures are governed by French law.

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APPENDIX 3

EXCERPTS FROM THE CDS CLEARING RULE BOOK (AS AT 10 JANUARY 2017)

EXCERPTS FROM THE CDS CLEARING RULE BOOK
(AS AT 10 JANUARY 2017)

Section 1.2.14 Governing law Article 1.2.14.1

The CDS Clearing Rules and the CDS Admission Agreement shall be governed by and construed in accordance with French substantive law unless explicitly stated otherwise.

Article 1.2.14.2

The CDS Clearing Supplement, the ISDA Credit Derivatives Definitions, any Cleared Transactions (and any related definitions or Clearing Notices issued in respect of the CDS Clearing Supplement, the ISDA Credit Derivatives Definitions or any Cleared Transactions) shall be governed by and construed in accordance with English substantive law.

Article 1.2.14.3

The Pledge Agreement shall be governed by and construed in accordance with Belgian substantive law.

Article 1.2.14.4

The FCM CDS Clearing Regulations (and any related definitions or Clearing Notices issued in respect of the FCM CDS Clearing Regulations), shall be governed by and construed in accordance with the laws of the State of New York, without regard to any conflicts of laws principles, and the laws of the United States of America, in accordance with the terms of the FCM CDS Clearing Regulations.

Article 1.2.14.5

Any non-contractual obligations (within the meaning of Regulation (EC) no. 864/2007 as may be amended from time to time) arising out of, relating to, or having any connection with the CDS Clearing Documentation, or any Cleared Transaction, shall be governed by and construed in accordance with either: (i) French, substantive law; (ii) English substantive law; (iii) Belgian substantive law; or (iv) the substantive law of the State of New York and the federal laws of the United States of America, as determined by this Article 1.2.14.5. Such non-contractual obligations shall be governed by and construed in accordance with:

(i) French law, where the non-contractual obligation is more closely connected to the CDS Clearing Rules (save the CDS Dispute Resolution Protocol) or the CDS Admission Agreement; or

(ii) English law, where the non-contractual obligation is more closely connected to the CDS Clearing Supplement, the ISDA Credit Derivatives Definitions, the CDS Dispute Resolution Protocol and/or any Cleared Transactions (and/or to any related definitions or Clearing Notices issued in respect of the CDS Clearing Supplement, the ISDA Credit Derivatives Definitions, the CDS Dispute Resolution Protocol or any Cleared Transactions); or

(iii) Belgian law, where the non-contractual obligation is more closely connected to the Pledge Agreement; or

(iv) the laws of the State of New York and the laws of the United States of America where the non- contractual obligation is more closely connected to the FCM CDS Clearing Regulations (and/or to any related definitions or Clearing Notices issued in respect of the FCM CDS Clearing Regulations).

Section 1.2.15 Dispute resolution

Article 1.2.15.1

All Disputes shall be referred to and finally resolved by arbitration or litigation as applicable in accordance with the CDS Dispute Resolution Protocol, subject to the provisions of Sections 8 and 9 of the Procedures. (…)

Article 1.1.3.8

The CDS Clearing Documentation shall be drawn up in English. Different language versions or translations of the CDS Clearing Documentation may be issued for information purposes. In the event of inconsistency between different language versions or translations of the CDS Clearing Documentation, the English language version of the CDS Clearing Documentation shall prevail over any other language versions or translations.

To the extent of any conflict between (i) any definition or provision contained in Appendix 1 of this CDS Clearing Rule Book; (ii) the remainder of this CDS Clearing Rule Book; (iii) the CDS Admission Agreement; (iv) the Pledge Agreement; (v) the CDS Clearing Supplement; (vi) an Index Cleared Transaction Confirmation or Single Name Cleared Transaction Confirmation (as applicable); (vii) the Procedures; or (viii) any Clearing Notices, the first referenced document shall prevail, except with respect to any conflict arising from this CDS Clearing Rule Book being governed by French law and the CDS Clearing Supplement being governed by English law in relation to determining the existence and/or amount of any payment and delivery obligations under any Cleared Transactions, in respect of which the CDS Clearing Supplement, the Index Cleared Transaction Confirmation or Single Name Cleared Transaction Confirmation, as applicable, shall prevail to the extent permitted by law.

APPENDIX 4

Questionnaire reviewed with banks' legal departments

QUESTIONNAIRE REVIEWED
WITH BANKS' LEGAL DEPARTMENTS

Objective: identifying impediments to/prerequisites for developing a service for trading and clearing short/long-term and listed/OTC interest rate derivatives in Paris.

The *Groupe Infrastructures de Place - Brexit* wishes to take advantage of this exchange with banks' legal departments to discuss, in particular, the following issues:

i. For the purposes of developing an interest rate derivative trading and clearing service in Paris, do the solutions implemented for clearing credit derivative trades (CDS) in Paris seem appropriate?

- With respect to the applicable law?

For reference purposes, the solution ultimately chosen by LCH SA when it set up a clearing service for credit derivative trades (CDS) in Paris, consists of distinguishing the rules of the central counterparty (membership, account management, margin calls, default of members, etc.), which are governed by French law, and the rules with respect to trades, which are governed by English law.

- In terms of dispute resolution method, should arbitration be preferred to court proceedings?

For reference purposes, in the event of a dispute in relation to the clearing of CDS in Paris, the courts in Paris and an English arbitration tribunal have respective jurisdiction.

More generally, it should be noted that the jurisdiction of the English courts should now be excluded, in particular due to the withdrawal of the United Kingdom from the EU, the loss of automatic recognition of British court decisions as from that date and the specificity of the subject in question.

- In terms of the arbitration tribunal with jurisdiction?

For reference purposes, an English arbitration tribunal has been preferred over an arbitration tribunal in Paris for disputes involving the clearing of CDS in Paris.

ii. What points of the solutions chosen for clearing CDS should be amended, if any?

iii. Are methods, approaches or solutions other than those proposed by LCH SA for clearing CDS conceivable or desirable?

iv. With respect to setting up an interest rate derivatives trading and clearing service in Paris and, potentially, transferring trade portfolios from the London financial markets to the Paris financial markets:

- Is it necessary to include grandfather clauses that would not oblige market participants to transfer their existing trades to Paris?

- On the contrary, should transfer mechanisms be offered enabling market participants to transfer their existing positions to Paris?

- In the event of a transfer of existing positions to Paris, this would require that the transfers be carried out in phases, depending on the relevant market participants and trades (as opposed to a "Big Bang", whereby all trades are transferred at the same time). Does this seem like the right approach to you from a legal and operational standpoint and, if applicable, what could be the procedures applied to these phases?

- If existing positions are transferred to Paris, it will also be necessary to organise the transfer of assets deposited as collateral to the French central counterparty without requiring market participants to over-collateralise. What are the main issues you have identified?

v. These questions do not preclude any other points you deem should be studied with respect to developing an interest rate derivatives service in Paris.

APPENDIX 5

Summary of the accounting and tax treatment of interest rate swaps for credit institutions and investment firms

SUMMARY OF THE ACCOUNTING AND TAX TREATMENT OF INTEREST RATE SWAPS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

Since 1992, the tax system applicable to interest rate and currency swaps (Article 38 *bis* C of the *Code Général des Impôts* - **"CGI"** - (General Tax Code)) has been adapted to take into account the accounting and tax rules applicable to these transactions when carried out by credit institutions and investment firms.

Since 1996, the scope of these provisions has been extended to forward rate agreements (FRAs) and other similar contracts, as well as interest rate caps, floors and collars.

For accounting purposes, when interest rate or currency swap contracts are entered into, they are reported separately in the off-balance sheet accounts in one of the four following classes, depending on their purpose, and specifically monitored:

- for individual contracts (class A): the financial flows are recognised prorated to time in accordance with the accrued interest rule. Provisions are recognised for unrealised losses on homogeneous groups of individual contracts, and unrealised gains are not recognised. Equalisation payments made or received when these contracts are entered into are progressively allocated to income over the term of the contract.

- for contracts used to hedge an identified item (class B), and whose purpose is to hedge, as from the time they are entered into, the interest rate or currency risk of an identified item or a homogeneous set of items: the financial flows of these contracts, including equalisation payments made or received, are recognised to the same extent as the flows in relation to the hedged item.

- for contracts used to hedge a global interest rate risk (class C), whose purpose is to hedge the institution's global interest rate risk on assets, liabilities and off-balance sheet commitments, excluding individual contracts and trade transactions: the financial flows are recognised prorated to time in accordance with the accrued interest rule, and unrealised losses are not recognised. Equalisation payments made or received are progressively allocated to income over the term of the contract.

- for contracts used for trading activities (class D), which are measured at their market value at each balance sheet closing date, and whose value is obtained by discounting, at the market interest rate at that date, the future financial flows attached to these contracts: the market value is adjusted by counterparty risk and future management expenses associated with the contracts.

For tax purposes, Article 38 *bis* C of the CGI lays down equivalent rules to those applied to determine accounting income, subject to, firstly, in particular the specific case of provisions for unrecognised losses on individual contracts and, secondly, the procedures for spreading equalisation payments in connection with contracts not measured at market value.