

The Law and Regulation of Central Counterparties

Jiabin Huang

(Oxford: Hart Publishing, 2010)

225 pp.

£75

*Christian Chamorro-Courtland**

The study of central counterparties (CCPs) is an esoteric and complex area of commercial, banking and financial law. Over the past decade, there have been several expert reports and articles written by economists, lawyers and policy-makers, who have attempted to describe the different facets of CCP operations. Dr. Huang's book is the first legal scholarly work which covers all the main issues in one place. This landmark piece of work comes at a time when CCPs have become a hot topic for debate and have caught the attention of policy-makers around the globe as a mechanism for reducing risks in the international financial markets.

This book is an expansion of Dr. Huang's Ph.D. thesis at King's College London, which he completed under the supervision of Professor Jan Dalhuisen — a leading academic in the field of transnational trade, commercial and financial law. Dr. Huang's expertise is supplemented by the experience he obtained whilst working at a world-leading CCP — the London Clearing House (LCH.Clearnet Ltd.). This is reflected in the real-life examples he gives throughout the book.

His work strikes a delicate balance between the legal aspects of the CCP systems both in theory and in practice, thereby serving as a useful manual for practicing lawyers, policy-makers and academics interested in learning about this increasingly important field. Further, this book analyses the legal and regulatory aspects of CCPs from a transnational perspective; that is to say, little reference is made to domestic legal regimes. Therefore, it transcends boundaries and can be used as a manual for CCPs by lawyers, regulators and policy-makers in any jurisdiction.

The book begins by providing an excellent roadmap with chapter summaries to guide the reader in the right direction. From the outset, Dr. Huang differentiates between "clearing houses", which operate as agents, and "CCPs", which operate as the principal to every transaction. This is important from a legal perspective, since the two clearing systems are legally distinct. A clearing house does not assume any obligations of the clearing members; whereas a CCP assumes all the obligations of the clearing members and guarantees their performance. Therefore, this work distinguishes itself from the majority of the literature dealing with CCPs, which typi-

* Ph.D. Candidate at Osgoode Hall Law School, York University; LLB, LLM, King's College London; Co-Chair of the Osgoode Graduate Law Students Association; Legal Process & Writing Instructor at Osgoode.

cally use the terms interchangeably.

The book does well to examine CCPs operations in the context of the global financial crisis (2007–2010), and it paves the way for future scholars to continue writing about the legislative and regulatory reforms which are set to be implemented to comply with the G-20 Pittsburgh initiative. Although the *European Market Infrastructure Regulation*¹ and Dodd-Frank Act² are not specifically mentioned, the book does an excellent job of outlining the issues which are currently being debated by policy-makers across the globe; for example, should a central bank have the authority to bail-out a CCP which is considered “too-big-to-fail”?

The author gives a good overview of the legal aspects of payments systems, securities settlement systems, modern indirect-holding structures, book entry securities, and the current and future shape of the post-trade infrastructure. This is done to set the scene before the legal aspects and operations of CCPs are discussed. It is done effectively without going into too much detail or providing too many examples, since other books cover these topics in more detail. It especially goes into detail on the nature of Delivery-Versus-Payment (DVP) and Straight-Through-Processing (STP), which are not adequately covered in the legal literature elsewhere.

Dr. Huang correctly suggests that “even though it is right to consider CCPs as part of the post-trade infrastructure, it arguably may be considered as inappropriate to subject them to the same regulatory/supervision regime as other post-trade providers, such as Central Securities Depositories . . . The Bank for International Settlements (BIS)’s Recommendations for CCPs in 2004 also proves the need for a different regime”.³ Although Dr. Huang does not go so far as to suggest what this different legal regime might be, I have argued elsewhere that CCP operations are recognised by a legal regime known as the new transnational *lex mercatoria*.⁴

The historical origins of CCPs are outlined very concisely. Dr. Huang describes how modern CCPs evolved from cheque clearing houses and commodity clearing houses to provide new operations to manage new risks. Using a CCP meant that clearing members could rely on the counterparty risk of one central counterparty instead of having to monitor the counterparty risk of several counterparties. Therefore, the “CCP clearing function is an alternative approach in conjunction with others like risk-sharing schemes or insurance schemes”.⁵

Dr. Huang accurately describes the CCP as “a specialised institution that has various functions”.⁶ The functional aspects of CCPs include the CCP operating as a risk manager, as a fund manager, as a payment and settlement system operator, and as a post-trade market facilitator. The operational aspects of CCPs include risk operations, treasury operations (which includes margining operations), and settlement

¹ EC Commission *Regulation on OTC Derivatives, Central Counterparties, and Trade Repositories*, COM (2010) 484/5.

² *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 2010, HR 4173.

³ Huang, at 14-15.

⁴ Christian Chamorro-Courtland, “Central Counterparties (CCP) and the New Transnational *Lex Mercatoria*” (2011) 8 *Florida State University Business Review* 57.

⁵ Huang, at 45.

⁶ *Ibid.*, at 52.

operations (which covers trade registration, the pre-netting stage, the netting stage, the post-netting stage, and the settlement stage).

This work deals briefly with the landmark House of Lords case of *British Eagle International Air Lines Ltd. v. Cie Nationale Air France*.⁷ This case was important because the decision gave priority to insolvency laws over clearing arrangements. This hindered the proper operation of CCPs in insolvency situations; viz., CCPs operating in common law jurisdictions were prohibited from performing multilateral netting if the mutuality requirement was not satisfied. Therefore, the legislatures in various common law jurisdictions intervened to pass special legislation⁸ protecting financial market CCP arrangements by exempting them from domestic insolvency laws.

Although this work does not look at the details of specific domestic legal regimes, a more detailed analysis of *British Eagle* would have been desirable.⁹ A deeper analysis of the *International Air Transport Association v. Ansett Australia Holdings Limited*¹⁰ decisions would have allowed the author to distinguish between financial market CCPs and non-financial market CCPs. Non-financial market CCPs operate in industries which are not connected to the financial markets, e.g., the International Air Transportation Association (IATA) clearing system for the world's airlines.

The book does well to differentiate between the two main types of counterparty substitution in CCP arrangements; "open offer" and "novation". However, *IATA v. Ansett* could have been used as a legal authority to demonstrate the legal nature of open offer in practice. In that case, the Australian High Court implied that open offer was the method of counterparty substitution intended to be used without actually using the term in their judgement. Thus, Dr. Huang could have used this authority to demonstrate how legal risk arises in practice.¹¹ Furthermore, he could have demonstrated the negative impacts of legal risk by expanding on the *British Eagle* case.

The book explores the legal issues regarding CCPs and the key relationships of the participants involved in a CCP arrangement (which covers the legal relationships between the CCP, the clearing members, and the clients of the clearing members). CCP arrangements must avoid "legal risk" in order to operate properly. Dr. Huang suggests that "the rules and regulations of CCPs themselves as market rules may further acquire the status of bylaws".¹² This argument is important because it implies that CCPs, as self-regulatory organisations, create rules that can be legally enforced in court. Although Dr. Huang does not refer to the *lex mercatoria*, his

⁷ [1975] 2 All E.R. 390, [1975] 1 W.L.R. 758 (U.K. H.L.).

⁸ E.g., the *Companies Act 1989*, Part VII, c. 40, ss. 154–191, was passed in England.

⁹ This book missed the opportunity to cite Professor Benjamin Geva's landmark article dealing with clearing houses and the *British Eagle* decision; Benjamin Geva, "The Clearing House Arrangement" (1991) 19 C.B.L.J. 138.

¹⁰ [2008] HCA 3. This case also dealt with the issue of the binding force of a clearing arrangement over insolvency laws.

¹¹ I have described the legal implications of these two cases in "Counterparty Substitution in Central Counterparty (CCP) Systems" (2011) 26 B.F.L.R. 517.

¹² Huang, at 74.

argument opens the forum for debating whether CCP rules should be governed by the new transnational *lex mercatoria*.

The book does an excellent job of describing the various default procedures in a CCP arrangement. This delves into issues of collateral and margin arrangements, netting and set-off (a distinction is made between settlement netting, close-out netting and novation netting), the financial resources a CCP has at its disposal in case a clearing member defaults, and the consequences which a CCP insolvency could have. Dr. Huang argues that “it is a highly unlikely event that a CCP may get into difficulty or even become insolvent, given the fact that in some cases it has the explicit backing of a central bank — as is required by law, for example, in France in the event that there is a potential consequence of market instability”.¹³ This sets the tone for the debate on whether a central bank should have the legal authority to bail out a CCP which is considered “too big to fail”.

Finally, the book covers the regulatory aspects concerning CCP arrangements. The different types of regulatory approaches are clearly outlined in general, followed by a detailed description of the regulatory situation in the European Union. Furthermore, Dr. Huang argues that “given the role of CCPs in both payment and securities settlement systems and the risks involved in using CCP clearing, central banks . . . have an intrinsic interest in their safe and efficient functioning”.¹⁴ The book ends with a chapter describing the advantages and disadvantages of having one single multi-market CCP, which is an issue that is being hotly debated and is extremely relevant for competition law purposes.

Overall, this book is well-written, it has few shortcomings, and the concepts are easy to grasp for anyone who is initiated in clearing and settlement systems. The book is accessible to anyone familiar with commercial, banking or financial law. It will remain a classic piece of work that will be remembered as the first of its kind. It could not have been published at a more opportune time, and it contains years of scholarly research that will be of great aid to regulators and public policy-makers in the years to follow.

¹³ *Ibid.*, at 122-123.

¹⁴ *Ibid.*, at 137.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.