REDUCING LEGAL RISK IN OTC ELECTRONIC TRADING

1. Introduction

The advantages of electronic trading over voice and paper dealing are widely known, and include speed of transacting, ability to accommodate vastly greater volumes, and reduced risk of error. Growth in the practice has been both supported and evidenced by the post-MiFID development of a number of multilateral trading facilities, including BATS Trading, Chi-X, Markit BOAT and Turquoise,[1] and electronic trading is widespread in over-the-counter ("OTC") markets for products such as spot FX, interest rate swaps and fixed income products.

In this way trading systems have become a fundamental part of the financial system, and as such are crucial to the future integrity and resilience of the markets. Accelerating their deployment by way of market-driven, standardised solutions is seen to be a key element in the reduction of the systemic risks made so apparent by the credit crisis.[2]

The processes of trade matching, confirmation and settlement that are supported and implemented electronically must be both technically reliable, and subject to a set of legal rules that ensures certainty over whether or not, when and where a trade is binding and what its terms are. In relation to OTC markets the application of basic legal doctrines to electronic trading – at least under English law – lacks the requisite certainty, which must therefore be regarded as a source of risk.

Legal uncertainties associated with electronic trading have been the source of debate for over 17 years, focussing initially on electronic data interchange in sectors such as insurance and automotive parts. Harmonised contractual terms and operational arrangements, appropriate to the market in question, governing the use of EDI as the medium through which trading partners do business emerged to fill the void. Although practices in the USA and Europe differ as to form, these model terms provide an effective surrogate legal regime.

The key elements of the solution are as follows:

- a set of binding standard messages with defined and accepted meaning;
- rules relating to the authenticity, integrity and reliability of the messages; and
- commercial terms agreed between the trading partners.

There are sufficient differences between practice in OTC markets and those markets in which EDI is prevalent to point away from wholesale adoption of EDI. However, from a legal and contractual perspective, we believe the OTC markets could benefit from the principles developed in the context of EDI to enhance the legal certainty surrounding the use of electronic platforms in the OTC markets. After the executive summary that follows we explain how that could be achieved.

2. Executive summary

- The legal principles surrounding the point at which a contract is made when parties communicate electronically are uncertain. Trading in the OTC markets is subject to those principles, but the procedures surrounding the population and communication of

[1] For further discussion see: http://www.fsa.gov.uk/pubs/international/joint_mifid.pdf
[2] See "Containing Systemic Risk: The Road to Reform", Counterparty Risk Management Policy Group III, August 6, 2008, in particular, Recommendations V-7 to V-9 on pages 32 to 33 and Section V: Enhanced Credit Market Resiliency.

trade confirmations arguably reduce the practical significance of the problem for the time being.

- However, as the timescales between trade matching and settlement are reducing, so the opportunity for parties to rely on a confirmation to flush out disputes becomes less. Moreover, in a volatile market with high profile insolvencies it is critically important from a credit risk perspective to know when and on what terms a counterparty is bound by a trade.

- The legal position would be improved considerably by the promulgation of message standards covering the trading process, making clear the nature and content of (amongst other things) an offer and acceptance. When these standards are adopted contractually, they could be supported by other terms regulating the issues which arise out of the use of an electronic medium as such, including when a message is take to be received. Experience with EDI could be used to inform the appropriate solution.

- Although parties could be left to devise their own solutions, the trade associations should be encouraged to take the lead.

3. <u>**The need for a solution**</u>

The principles of contract law within which electronic trading takes place are of some antiquity. The rules have evolved to govern a multiplicity of commercial and other relationships which are often characterised by factual uncertainty. By and large they allocate risk efficiently. Therefore, there is no reason to believe that the law is in need of reform, but rather - for the reasons which follow - there is a pressing need for a market-driven solution which defines the instance of an electronic trade and its terms.

3.1 <u>The need for an agreed choice of law</u>

The question of whether a binding contract has been concluded is determined according to the applicable governing law. Where the parties have agreed which law applies, that will normally be the end of the matter, but where they have not done so, the choice of law is settled by reference to private international law, and so is likely to be the law of the country with which the contract is most closely connected.

As indicative of the complexities inherent in this area, the 1980 Rome Convention on the Law Applicable to Contractual Obligations informs relevantly that:

> "*[it] shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of a body corporate or unincorporate, its central administration. However, if the contract is entered into in the course of that party's trade or profession, that country shall be the country in which the principal place of business is situated or, where under the terms of the contract the performance is to be effected through a place of business other than the principal place of business, the country in which that other place of business is situated*."[3]

The presumption does not apply if characteristic performance cannot be determined or it appears that in the circumstances the contract is more closely connected with another country. It is not difficult to conceive of material questions arising in the context of cross-border OTC trading. Although these issues are not unique, the location of a trading

[3] Convention on the law applicable to contractual obligations: 80/934/EEC - Article 4.

platform in a third country adds a layer of complexity which would be avoided by an explicit choice of law.

3.2 Lack of certainty over the rules relating to pre-contract communication

The rules on communication of acceptances under English law neatly illustrate the difficulty of applying principles which have evolved in relation to conventional methods by analogy to electronic media. Generally, a communication is not effective until it is received. Hence, a contract is made by telephone when the offeror hears the offeree's acceptance, and a fax is taken to have been received when sent or, if later, when the message is available to the recipient. The notable exception is the postal rule under which an acceptance sent by post is effective when posted, not when it is received, provided it is reasonable to use the post.

It is not yet settled in English law whether the rule regarding instantaneous messaging or the postal rule applies to electronic communication. If the former applies, then the message will be deemed to have been received once it is made available to the recipient. By comparison, in the case of the latter, the message will be deemed to have been received as soon as it is sent regardless of whether it is actually delivered. A case can be made for the application of either – after all, electronic communication is for all practical purposes instantaneous, but the introduction of a third party value added service provider invites analogy with use of the postal service.

3.3 Master agreements do not prescribe the rules of formation

Master agreements provide an obvious place to set out the rules regarding formation of deals. However, two of the leading forms do not do so.[4] The 1992 (and 2002) ISDA Master Agreement and the Global Master Repurchase Agreement provide the following respectively:

> "*The parties intend that they are legally bound by the terms of each Transaction from the moment they agree to those terms (whether orally or otherwise). A Confirmation shall be entered into as soon as practicable and may be executed and delivered in counterparts (including by facsimile transmission) or be created by … an exchange of electronic messages on an electronic messaging system, which in each case will be sufficient for all purposes to evidence a binding supplement to this Agreement*.";[5] and
>
> "*A Transaction may be entered into orally or in writing at the initiation of either Buyer or Seller. Upon agreeing to enter into a Transaction hereunder Buyer or Seller (or both), as shall have been agreed, shall promptly deliver to the other party written confirmation of such Transaction (a "Confirmation") [setting out the key terms of the Transaction] .... The Confirmation relating to a Transaction shall, together with this Agreement, constitute prima facie evidence of the terms agreed between Buyer and Seller for that Transaction.*".[6]

Needless to say, the absence of a contractual regime opens the parties to the uncertainties associated with the applicable law.

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[4] For a further discussion of the ISDA architecture see: "*A New Master Agreement for the New Millennium: The Development of the 2002 ISDA Master Agreement*": Richard Tredgett and John Berry, Journal of International Banking and Financial Law (2002) 5 JIBFL 197 1, May 2002 and for general commentary about the use of standard agreement in the context of derivatives see: "*The European Master Agreement and its Derivatives Annex*" Pierre Lastenouse, Journal of International Banking and Financial Law (2004) 6 JIBFL 210, 1 June 2004.
[5] Section 9(e)(ii), ISDA Master Agreement.
[6] Sections 3(a) and (b), Global Master Repurchase Agreement.

3.4 Confirmations are post-trade

The confirmation process is hugely significant in practice in relation both to trade formation and the clearing of its terms. Once a match takes place, the commercial details of the trade are set out in the confirmation. This is taken to be evidence of the deal and its terms if no objection is raised promptly.

For the most part this process operates satisfactorily: where a confirmation is not disputed, settlement occurs in the ordinary course; and where an objection is raised, the current periods of T+2, T+3 et al allow time for issues to be addressed. However, market and regulatory pressures are operating to reduce settlement timeframes, amongst other things, through the use of straight through processing, to T+1 and even T+0. That environment makes it difficult, if not impossible, to resolve issues without delaying settlement, and in the current economic climate, it is of particular concern that one party may suffer an insolvency event before a dispute is resolved and settlement occurs.

The formal legal position is at variance from market practice, insofar as confirmations are generated *after* formation of the contract. As such they are evidence of the existence of a deal and its terms rather than influencing whether or not an agreement exists in the first place. Moreover, where a confirmation is not agreed, a lacuna arises whether or not a binding trade is concluded at all, and even where that is the case, what the key terms are.

Further, the status of confirmations as necessarily post-trade, and therefore as effective to evidence deal terms but not deal existence, is not entirely clear. It is widely acknowledged that, in the absence of a confirmation, there is as a matter of market practice scope for discussion regarding whether a trade was made. Of course, extraneous evidence - trade tickets, system records and the like – may settle the issue but the point for present purposes is that confirmations are regarded as sufficiently critical to the deal process for their absence to be able to cast doubt on the very existence of a trade. This supports even more strongly the need to reduce uncertainty regarding when a binding OTC trade is concluded.

3.5 Solutions in agreements with platform providers

Attempts by third party platforms to legislate for when a trade becomes binding do not resolve the issues highlighted here, as they lack binding legal effect as between the counterparties to the trade. An example may be if the terms of engagement of a platform provider state that a trade becomes legally binding at the point at which its server records acceptance of an offer. Issues of privity of contract generally arise to undermine the efficacy of such attempts. As a matter of English law, there is scope to examine the potential utility of the Contracts (Rights of Third Parties) Act 1999 in these circumstances, and it should not be an insurmountable obstacle to such utility that the 1999 Act applies to enable a third party (in this case the trading counterparty) to claim a contractual benefit without being concurrently burdened by a contractual obligation. Having said this, it is unlikely that there would be any significant appetite on the part of platform providers to permit themselves to be imposed into the logistics of a trading dispute between users of their system, with its attendant costs and administrative burdens.

4. Contractual adoption of standard trading messages

This paper asserts the desirability of adopting industry-wide proforma electronic message standards that establish, according to a nominated governing law, when an electronic trade becomes binding and the essential terms of the trade. At first blush, any of the leading common law jurisdictions would be suitable as a choice of law.

The adoption of pro forma messages could be supported by harmonised contractual rules regarding offer and acceptance, and hence greater certainty as to the trade process. Inevitably, such a development would concomitantly reduce, if not obviate altogether, the need to rely upon extraneous evidence to establish when and where a trade was made. The standards would not avoid the need for a confirmation (which could presumably be populated automatically from the previous exchange of messages), but the exchange of populated standard messages, when read in conjunction with an underlying agreement, would clarify the point at which the trade is concluded. This solution would be well suited to the speed, volumes and automation involved in electronic trading and hence should also be well placed to accommodate the pressures referred to above towards narrower settlement timeframes.

4.1 Format of the standards

The standards would make clear, according to the selected governing law, what constitutes an offer and an acceptance. The format should include data fields which when populated establish the key terms of the trade. For example: a proforma message that an offer was being made capable of immediate acceptance could be generated by a trader for Bank A posting a bid/offer spread onscreen for a specific instrument (with the message capable of delivery to all potential counterparties expressing an interest in that particular trade), while a separate message to Bank A expressing acceptance would be generated by a trader for Bank B pressing “send” (or equivalent phraseology) on that spread. Similarly, in the context of an RFQ system, posting a price or spread could generate a proforma message that it did not constitute an offer capable of immediate acceptance.

4.2 Promulgation of message standards

We propose that the trade representative bodies and associations currently responsible for the relevant master agreements: ISDA, the Global Bond Repo Association, Options and Futures Association and so forth be encouraged to promulgate message standards appropriate for their markets. The idea would be to mandate the form and content of the messages, or at least the essential features so that trading parties were able to tailor a solution to their own needs.

There seems little need also to mandate technical standards for the messages (as opposed to the message content). We believe service providers (BARX, Bloomberg, Reuters, Tradeweb and so forth) are best placed to develop technical templates within networks. It would then simply be the responsibility of counterparties to ensure the compatibility of their systems with the network’s specifications.

4.3 Contractual adoption of standards

As a market-driven solution, we propose that the standards are adopted contractually by the trading parties. Their use could be reflected in the relevant master agreements (ISDA Masters, Global Bond Repo Master et al), bespoke bilateral framework agreements between trading partners, or through on-line terms of trade.

5. Measures to protect against the inherent weaknesses of electronic communication

The focus of section 4 is the substantive content of the trading messages and their legal effect. However, a number of material issues remain when electronic systems are used to communicate. They concern the ephemeral nature of electronic messages and the ease with which messages may be intercepted, diverted or compromised during preparation, transmission and storage, particularly in the case of open systems and the internet.

Although the very speed with which transactions are concluded in real time, to a degree, may avoid or mitigate some of the problems, in our view the markets would benefit from a harmonised contractual solution to these weaknesses, including provisions dealing with message processing, such as receipt,[7] acknowledgment, security and record keeping; and enforceability, such as support for a message's authenticity (i.e. assurance that the message is from the person who purports to have sent it), integrity (i.e. the message received is the same as the message sent) and validity.[8]

In the field of EDI these provisions are contained in interchange agreements (Europe) or trading partner agreements (USA). Perhaps the most pragmatic solution in the context of OTC trading would be for the trade representative bodies and associations to cover these issues in their master agreements, which would then set the model for other sectors of the industry. However, we believe the provisions are appropriate for the contractual relationship between the trading parties and not the platform providers.

6. Concluding remarks

The legal uncertainties that surround the point at which a trade is concluded electronically are not unique to the OTC markets. However, they nevertheless pose a material risk to the integrity and resilience of the markets, as compressed timescales between trade formation and settlement undermine the market practice of relying on confirmations to flush out disputes. The adoption of harmonised message standards, supported by effective contractual governance, would go a long way to providing the requisite legal foundation.

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[7] A typical solution in the context of EDI is that the message is received when it is *accessible* by the receiving party, but not before: see Article 15(2) of the UNCITRAL Model Law on Electronic Commerce 1996 On this basis, where a third party platform provider is involved, the message would not have to reach the counterparty's own system for it to have been effectively delivered and for the counterparty to be bound by it. The solution seems pragmatic because the recipient will not know if a message has been sent, whereas the sender will know he has sent the message and so, for example, able to follow up if an expected response is not received.

[8] These are of course regulatory requirements to be complied with: by way of example, the UK FSA's SYSC standards mandate that regulated businesses take reasonable care to establish and maintain appropriate security systems and controls and regularly review those systems and controls. The Senior Management Arrangements, Systems and Controls (SYSC) in the FSA's handbook can be found on line at: http://fsahandbook.info/FSA/html/handbook/SYSC.

[9] Our thanks go to Andrew Scott, Partner, Chris Gelber, Director, and Gill Hough, Solicitor for their authorship of this paper.