

Consequently, issues (i) to (iv) would not typically arise commercially in relation to OTC derivatives contracts. The firm's records would not, therefore, be comparable to securities accounts maintained by an account provider any more than other accounting records noting the identity of the firm's ordinary creditors.

Some derivatives contracts (such as forward sale contracts) require the delivery of a commodity or security at maturity. The record of the derivatives contract in the firm's books is unlikely to represent an entitlement to the commodity under common-law systems, since an ownership interest does not arise under sales of goods laws until a specific asset has been allocated to the contract. A similar conclusion would be expected in relation to common-law contracts for the future delivery of securities.

3. **Futures contracts**

Firms will commonly adopt a similar approach to recording exchange-traded derivative contracts entered into by the firm on behalf of clients. The difference here is that the client's instructions will be in effect an "order" executed on the client's behalf, so there is usually a second contract corresponding to the order, but existing between the firm and its market counterparty.

While market rules commonly require firms to trade in the market as principal (thus replicating the contractual OTC structure where the firm has hedged the arrangement agreed with the client), this is not invariably the case: clients may have a direct entitlement against the exchange or CCP. However, there are differences from the record of a securities entitlement, such as the following:

- (a) *Non-material nature.* If a client holds a long position (eg a contract to buy 100 lots of an index in 3 months' time at a price of EUR 10000), it can easily close out this position by entering into a short position (a contract to sell 100 lots of the same index for the same delivery date at today's price, which is EUR 9000). If it does so, the positions cancel out. There is no finite amount of "product", so that concerns about the effect of shortfalls on title do not arise¹.
- (b) *Margin.* Exchange-traded derivatives almost invariably need to be supported by cash or other collateral ("**margin**"). If the client defaults in provision of margin, its broker may close out the client's position - in other words its entitlement will disappear.
- (c) *Transfer.* The market mechanisms for transfer are extremely limited. If a client wishes to acquire a particular futures contract, it will instruct its broker to take a long position - ie to go into the market and buy. If a different client wishes to dispose of its contract, it will instruct its broker to take an offsetting short position. Thus, no need for transfer arises unless the broker is insolvent or is surrendering its market participation. Complex arrangements can allow clients to "transfer" positions to other brokers, provided that margin is put up by the client to the new broker. It is difficult to analyse these structures to transfers of securities.

Issues (i) to (iv) would seem to be very different for exchange-traded derivatives contracts by comparison with securities credited to accounts.

4. **Give-up Agreements**

In some markets (typically futures markets) orders are executed by one broker and then "given up" for clearing² to another broker. Entitlements to contracts subject to a give-up arrangement are no different from other derivatives contracts as discussed above. The purpose fulfilled by the give-up agreement is to discharge the executing broker's obligations to the investor and to create like obligations on the part of the clearing broker. There is no "transfer" of the entitlement, and no centralised or other register on which a book entry is made representing the investor's entitlement throughout the process.

¹ There are legitimate concerns about market abuse for physically-settled contracts, where a squeeze is applied and the value of closing-out contracts rises as holders of short positions seek to obtain the product to satisfy their delivery obligations, but this is not a question about risk to title.

² In this note "clearing" means the process by which a central counterparty becomes guarantor of the counterparty risk on a transaction.

5. Commodities and Emissions Allowances

A final question arises whether centralised records of entitlement to commodities, which may be relevant in the context of exchange-traded commodity futures contracts, might raise issues similar to those applicable to book entries of entitlement to securities.

One system where there is a centralised register of entitlement to commodities is the SWORD system. This is a system operated for the London Metal Exchange, which is a record of bailees of warehouse warrants (possession of which may, but will not always, entitle the possessor to delivery of the goods: LME warrants are not exclusively UK-origin instruments). In an indirect sense the SWORD register is a record of entitlement to a commodity. The system depends on the common-law concept of bailment, does not purport to be a register of ownership of goods, and has explicit rules which do not appear to have given rise to substantial issues of legal uncertainty.

Similar registers of entitlement may exist in member states in respect of emissions allowances created for the purpose of Directive 2003/87/EC. Directive 2003/87/EC does not, however, prescribe a legal status for emissions allowances, and the classification of them differs between member states and in some cases is undecided. For example, an allowance may be a pecuniary benefit existing at the discretion of a state authority personal to the holder (like a tax rebate) or it may be a species of transferable property. There is as yet no single settled protocol for holding or settlement of transfers of emissions allowances. While it is possible that registers of entitlement to emissions allowances share features similar to securities accounts or SWORD, in relation to a species of property in the infancy of its existence no generalisation is possible.

6. Conclusion

"Settlement" of derivatives does not involve any different form of settlement from other transactions; although at the maturity of the transaction a cash payment or delivery of securities or commodities may be required. During the lifetime of a derivative transaction, "settlement" (in the sense of effecting a transfer of entitlement to a contract from one investor to another) does not occur, since the concept of transfer does not in practice exist other than in remote contingencies, and even then "transfer" is effected by discharge of the "transferor's" contract and creation anew of a contract in favour of the "transferee".

Although investors may refer colloquially to "derivatives contracts in my account" just as they refer to "cash in my account" or "securities in my account", there would appear to be little overlap between the concepts of entitlement and legal questions that arise in the context of book entry securities and those relating to derivatives.

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