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The 'Hedging or Speculation' Question in Determining the Capacity of Public Bodies to Trade Derivative Transactions

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*London School of Economics. If not already declared, please include details of any funding in a footnote at the beginning of the article, including funder name and grant/award number. (Ideally the Funder Name should be spelled exactly as it appears on the Open Funder Registry. A copy of which can be found (In several formats) at the following location: https://www.crossref.org/services/funder-registry/.) I am very grateful to Jonathan Ross for his comments on an earlier version of this article. Any views, opinions or errors remain mine.

Key points

- First, the article discusses how English courts assess the capacity of public bodies to engage in derivative transactions, focusing on whether these are for hedging or speculative purposes. The capacity to contract is crucial, as without it, contracts are considered 'ultra vires' (beyond the powers) of the public entities involved.
- Second, the article highlights the role of court decisions in shaping public policy related to financial market practice, particularly in the use of derivatives by public bodies. These decisions not only address legal capacity but also broader systemic risks, emphasising the need for a balance between legal principles and minimisation of systemic risk in light of public bodies' significant exposure to financial markets.
- Third, based on a review of case law, the article considers whether the distinction between hedging and speculation should be based on an objective test (focusing on the transaction's nature and purpose) versus a subjective test (based on the entity's intention). The article proposes an objective test and suggests that the distinction between hedging and speculation is critical in determining the legal standing and risks associated with the public body's derivative transactions.

1. Introduction

The article is about how English courts have dealt with the question of whether a public body is hedging or speculating in derivatives as a means to determining its capacity to contract. Public bodies are significant investors in financial markets.[1] Derivatives comprise a large segment of this.[2] Emanating from public law, local governments, state owned companies, municipalities, central banks and government ministries are examples of public bodies.[3] They may enter

[1] See Section 'Exposure of public bodies' of this article on the exposure of public bodies to derivatives. See also, Bank of England, 'Local Authorities and the Capital and Money Markets' (1996) Quarterly Bulletin, pt 2(A). As far back as 1996, local authorities in the UK have had to finance their capital expenditure by borrowing from the capital and money markets.

[2] Derivatives are bilateral contracts with rights and obligations of parties referencing underlying variables. See Joanna Benjamin, *Financial Law* (OUP 2007) 64–77.

[3] In England, this includes the Council of the City of London, county councils, borough councils, amongst others. See Localism Act 2011, s 8(1).

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derivative contracts to manage risks in investments.[4] They must have capacity to bind themselves to derivative contracts otherwise those contracts are 'ultra vires'. A public body's capacity to contract invariably depends on the legal instrument establishing the entity, as well as the laws of the jurisdiction in which it is established. In the derivative market, practitioners use articles of associations, incorporation documents and sometimes shareholder agreements to determine the capacity (or limits thereof) of a counterparty to enter derivatives.[5] For a public entity, the relevant documents will include resolutions and authorizations from statute and analogous legal instruments. The important point in these situations is that nothing should explicitly prohibit derivatives.[6] Public bodies, however, have specific public purposes that prohibit transactions less those transactions directly lead to loss of taxpayer money.[7] The general rule in English law is that a lack of capacity means the entity in question has not made a valid contract.[8]

In three recent decisions *Deutsche Bank v Comune di Busto Arsizio* [2021] EWHC 2706 ('*Comune Di Busto Arsizio*'); *Dexia Crediop SPA v Provincia Di Pesaro E Urbino* [2022] EWHC 2410 (Comm) ('*Urbino*') and *Banca Intesa Sanpaolo Spa & Anor v Comune Di Venezia* [2023] EWCA Civ 1482 ('*Comune Di Venezia*'), the English courts have had to consider the capacity of Italian public bodies to enter into derivative transactions. Relevant to all three decisions has been the question of whether the relevant public body is hedging or speculating through derivative transactions. The approach of the English courts to this question has been said to differ from those of other courts, with banks proving less successful in their claims that public bodies have entered into valid hedging transactions.[9] The approach of the English courts is also subject to the influence of both policy and judicial decisions in other courts. Take the example of Italy. In 2020, the Joint Sections of the Italian Supreme Court of Cassation issued Decision No 8770/20 ('*Cattolica*') holding that for the purposes of Italian law, a local authority did not have capacity to enter into speculative derivatives and that certain derivatives could constitute indebtedness.[10] This was a highly significant factor in how the courts in one of the recent cases, *Comune Di Venezia*, determined the capacity of an Italian public body.[11] The decision in Cattolica was equally significant to the finding of Cockerill J in *Comune Di Busto Arsizio* where another Italian local authority sought to argue that interest rate derivatives entered into by it were void for lack of capacity. Whilst the derivative transactions in *Comune Di Busto Arsizio* were upheld, some doubts were expressed about the reasoning in *Cattolica*.[12] It is against this recent background that the English courts have been faced with a number of interesting questions which straddle the legal issue of capacity on the one hand and the issue of financial market practice pertaining to how a derivative is being used on the other. There is significant commentary on the issue.[13]

4 Issued bonds are an example. See *Dexia Crediop SpA v Regione Piemonte* [2013] EWHC 1994 (Comm). This involved an Italian local authority entering into interest rate derivatives to manage issued bonds. For treatment of derivatives in the context of public debt, see Gustavo Piga, *Derivatives and Public Debt Management* (International Securities Market Association (ISMA) in cooperation with the Council on Foreign Relations, 2021).

5 English companies, eg—s 31(1) of the Companies Act 2006 states that 'unless a company's articles specifically restrict the objects of the company, its objects are unrestricted'. Similarly, s 39(1) states that 'The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution'.

6 Shareholders/board resolutions and public body statutes are examples of legal documents that could prohibit particular transactions.

7 For a treatment of local authority speculation, see Alexander Kolar, 'Hammersmith Meets Orange County: "Wishing upon a Star" with Taxpayer Money in the Municipal Bond Derivative Market' (1996) 49 Urban Law Annual; Journal of Urban and Contemporary Law, 315, 319–332.

8 *Haugesund v DEPFA* [2010] EWCA Civ 579, Aikens LJ at [60] ('*Depfa*').

9 Enyo Law, 'The Mis-selling of Swaps: Facts and Law in Perfect Harmony' (2023), section on 'An international law perspective', 3.

10 *Comune Di Venezia*, Flaux LJ, [12].

11 ibid.

12 ibid [13].

13 For application of the Localism Act under English law, see Ashley Bowes and John Stanton, 'The Localism Act 2011 and the General Power of Competence' [2014] PL 392. For ultra-vires and restitution, see Adrian Briggs and James Edelman, 'Restitution and not-So-local Authority Swaps' (2010) 126 LQR 500. For the impact of case law on management of local authorities, see Andrew Arden, 'Hazell and the Ghost of Christmas Past: A Note on Financial Management' (2001) 4 J Local Gov Law 80–83. For the general issue of ultra-vires: ACL Davies, 'Ultra Vires Problems in Government Contracts' (2006) 122 LQR 98–123. For positive treatment of *Standard Chartered Bank v Ceylon Petroleum Corporation* [2012] EWCA Civ 1049 (CA) ('*Standard Chartered (CA)*') and its distinguishing features from *Hazell v Hammersmith and Fulham London Borough Council* 1992] 2 AC ('*Hazell (HOL)*'), see Daniel Franks, 'Leaving Hammersmith and Fulham for Ceylon' (2012) 27 BJIB & FL.

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The above referenced commentary, however, lacks direct proposals on how capacity disputes and their relationship with the distinction between hedging and speculating in derivatives should be determined. Braithwaite contends that this distinction should be rejected.[14] This represents the only part of the literature that directly addresses this question. Mckendrick also observed that the problem with the distinction is that validity of the transaction depended on the purpose of the derivative.[15] This article suggests that the distinction between hedging and speculating relating to the specific question of whether a public body has capacity in derivatives is highly significant. In light of recent decisions from the English courts, the arbitral decision of the International Centre for Settlement of Investment Disputes (ICSID) in *Deutsche Bank v. Democratic Socialist Republic of Sri Lanka* [2012] ICSID Case No ARB/09/2[16] ('*Deutsche Bank*') serves as a key point of focus. This has also received minimal attention. Following this, this article has two simple aims. First, it offers a consistent normative framework, which courts and tribunals can use to determine when public law capacity exists for derivative transactions, primarily through endorsing the objective test in the *Deutsche Bank* decision. Second and through a review of the case law, it suggests that English law has the capacity to engage with the distinction between hedging and speculation, with the judgement in *Comune Di Venezia* illustrative of this point.

It is important to briefly contextualize the above two aims within the framework of public and private law within which these disputes sit. This context is seen in the academic commentary, with Loughlin referring to the fact that the infamous case of Hazell v Hammersmith and Fulham London Borough Council [1992] AC 1 (*Hazell (HOL)*) prompted re-examination of whether courts were the most appropriate agencies for dealing with public litigation matters.[17] The concerns raised by Loughlin have become more international. Rather, what we now see in recent cases on the capacity of foreign public law entities is English courts dealing with a significant amount of jurisdictional, restitution and substantive conflict of laws questions. In order to resolve the many facets which these disputes can take, clear policy on permissible derivative activity remains important. The UK has taken a step in this direction by requiring that local authorities formulate investment strategies which outline their approach to risk.[18] Derivative use by public bodies is also only permissible with explicit approval by HM Treasury.[19] In Italy, similar restrictions are found in the *Cattolica* decision alongside the Italian Constitution. In these and many jurisdictions therefore, there is a requirement for the use of derivatives to be accompanied by policies providing public entities with clear parameters when entering such transactions. This helps to better determine the limits of a public body's activity, a determination that will be relevant to finding in court whether they have hedged or speculated and which activity they have capacity to undertake. Review of the cases in this article suggests that courts and tribunals can indeed resolve these disputes in a way that minimizes systemic risk in the context of public entity exposure to financial markets. This approach can always be facilitated by clearer government policy, as derivatives continue to serve as important risk management tools in public financing. Consequently, a combination of a consistent normative framework premised on an objective test as outlined in this article and clear public policy on permissible derivative activity serve as important protections of not only tax-payer money, but also a minimization of systemic risk.

[14] Jo Braithwaite, 'Thirty Years' Law: Local Authorities, National Courts and the Global Derivatives Markets' (2018) Curr Leg Probl 21.

[15] In context of discussing the Court of Appeal's approach in *Hazell v Hammersmith and Fulham London Borough Council* [1990] 2 QB 697 (CA) ('*Hazell COA*'). Ewan Mckendrick, 'Local Authorities and Swaps: Undermining the Market' in Ross Cranston (ed), *Making Commercial Law: Essays in Honour of Roy Goode* (201–237, Clarendon Press 1997).

[16] ICSID Case No ARB/09/2, Award, 31 October 2012; ICSID Case No ARB/09/2, Dissenting Opinion. <https://www.italaw.com/cases/1745>; Academic commentary on *Deutsche Bank* addressing treatment of derivatives transactions is seen in David W Rivkin and Mark W Friedman, Ch 5, 'Financial Products as Investments under Bilateral Investment Treaties and Other Multilateral Instruments with Consents to Arbitration', in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes: Arbitration and Mediation* (OUP 2015) 5.69, 5.84, draft copy on file with author, final version published by Oxford University Press.

[17] Martin Loughlin, 'Innovative Financing in Local Government: The Limits of Legal Instrumentalism: Part 2' (1991) PL, Winter Issue, 568–599, 598.

[18] See eg 'Statutory Guidance on Local Government Investments' (3rd edn) issued by the Secretary of State under s 15(1)(a) of the Local Government Act 2003.

[19] See HM Treasury, *Managing Public Money* (2023) 47, 5.12.3.

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The article is structured as follows. Section 2 provides an introduction to conflicting decisions on the question of whether a public body is hedging or speculating in derivatives. Section 3 explores some of the legal concepts employed by the English courts in finding capacity of public bodies. Section 4 outlines the reluctance to distinguish between hedging and speculation. Section 5 analyses this reluctance and suggests that English law has the capacity to engage with the distinction. Section 6 concludes.

2. Conflicting Decisions

This section outlines the article's first point that adjudication of disputes in the specific context of public bodies and derivative contracts requires sensitivity to systemic risk issues. The dispute in *Deutsche Bank*, in light of two cases which accompanied it is the focus.[20] In making this point, this section proceeds as follows. First, it outlines the exposure of public bodies to the derivative markets. Second, it provides an introduction to the legal uncertainty involved in conflicting decisions on capacity. Third, it suggests that the result of these disputes is a need to develop legal principles to finding capacity against the backdrop of systemic risk in the context of public bodies and their significant exposure to derivative markets.

Exposure of public bodies

Public bodies are globally exposed to derivative markets. France reported €11 billion in outstanding notional amounts involving 1,000 cities.[21] In Italy, Dodd reports that there were 467 cities involved in transactions with €2.5 billion outstanding.[22] The Italian Ministry of Economy and Finance, however, estimates that this is much higher. Ending 2014, the Ministry reported that 216 public authorities entered into 433 derivative contracts with a notional value of approximately €24.8 billion.[23] There is nonetheless some discrepancy in the data.[24] Data for Germany are not available, but at least 50 cities are said to have derivatives transactions with Deutsche Bank alone.[25] In the USA, at least 40 states passed laws authorizing municipal authorities to trade derivatives, with estimations totalling $250–$500 billion.[26] These numbers are only a snap shot, since many have not publicized bad trades.[27] In the UK, the Divisional Court's judgement revealed in 1990 that a local authority, Hammersmith and Fulham London Local Council entered into 592 transactions involving a notional sum of £6 billion. By comparison, the council's expenditure amounted to £85.7 m.[28] Taken together, the size of the derivatives market coupled with the significant exposure of public bodies' around the world means that decisions on capacity disputes can result in an exacerbation of systemic risk. This systemic risk is reduced by governments regulating the type of exposure undertaken by public bodies. One example is the Dutch Government banning speculation by public bodies in derivatives.[29] More recently and in the introduction to this article, the decision in *Cattolica* held that Italian local authorities did not have capacity to enter into speculative derivatives.[30] These prohibitions on public body activity in financial markets are necessary because clarity on the permissible conduct of such bodies makes it significantly easier to reach decisions on whether such bodies are hedging or speculating in financial markets. This is considered more specifically in Section 5. For present purposes and

[20] The first: *Standard Chartered (CA)*, see (n 13). See also the High Court case from which the appeal emanated from, *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) ('*Standard Chartered (HC)*'). The second: LCIA No 81215, First Partial Award, 31 July 2011 ('*Citibank*').
[21] Randall Dodd, 'Municipal Bombs' (2010) 47 IMF Finance and Development 33.
[22] ibid.
[23] Norton Rose Fulbright, 'Derivatives Mis-selling Claims by Public Authorities' (November 2015).
[24] See Dodd (n 21). Dodd reports that 467 cities have entered these transactions, with €2.5 billion outstanding, whilst The Italian Ministry of Economy and Finance reports 137 smaller cities with EUR 1.5 billion. The Italian Central Bank in 2008 banned public authorities from entering into swaps, and this may have contributed to the lower figures that are publicly available.
[25] ibid.
[26] ibid.
[27] ibid.
[28] *Hazell v Hammersmith and Fulham London Borough Council* [1990] 2 QB at Appendix B.
[29] Simmons and Simmons, 'Dutch Restrictions on Use of Derivatives by (Semi) Public Bodies' (2013).
[30] Referenced in *Comune Di Venezia*, Flaux LJ, [12].

considering the exposure of public bodies described here, conflicting decisions about these issues can serve as a small[31] but important source of systemic risk. This is considered below.

Disputes as a source of risk

The conflicting result of the dispute between a number of banks and the Ceylon Petroleum Corporation ('CPC') is a direct example of uncertainty in the determination of capacity. CPC is a Sri Lankan state owned company. It is considered a public body, as it is controlled by the Sri Lankan government and accountable to the public. It entered into derivative transactions in February 2007 with Deutsche Bank, Standard Chartered and Citibank. Though similar, the transactions in the *Deutsche Bank* case were different from those in the *Standard Chartered (CA)* and *Citibank* cases. The article focuses on the transactions in *Deutsche Bank*, as ICSID's decision on those transactions serve as the basis for focusing on the question of whether such public entities are hedging or speculating in derivatives. The particular derivative transactions with Deutsche Bank were concluded on 8th July 2008.[32] Sri Lanka had the burden of proving that the transactions entered into by CPC—which prima facie constituted investments—were speculative and outside its capacity. The Tribunal found that CPC had capacity to contract.[33]

The trade required Deutsche Bank to make payments to CPC when oil prices were high. Conversely, CPC was required to make payments to the banks if the price of oil fell, in particular, below an agreed floor. A floor is a limit providing insurance against a falling price—in this case, that asset price was oil. Payments are contingent on the price of the underlying asset (oil) on each payment date. In late July and August 2008, oil prices fell rapidly. The price at which CPC was able to purchase oil also fell. However, the derivative transactions that CPC had entered into were negatively correlated to the price of oil, which meant that, as physical oil prices fell, CPC became 'out-of-the-money' on its derivative transactions.[34] This meant CPC had an obligation to pay the difference between the strike price and the oil price for the relevant months, multiplied by the number of barrels. CPC refused to satisfy this obligation.[35] In *Deutsche Bank*, Sri Lanka made the argument that the ICSID Tribunal lacked jurisdiction. It argued that the claim in contract based on CPC's failure to pay amounts, being due to Deutsche Bank under the transaction discussed above were inadmissible based on incapacity.[36] This case brought with it a number of significant legal issues. It considered the wider question of whether derivative transactions constituted investments under the Germany—Sri Lanka Bilateral Investment Treaty and international law. The Tribunal held that derivatives were indeed investments. This was accompanied by a strong dissent arguing the opposite. Analysing this part of the Award is beyond the scope of this article.[37] The focus is on resolution of the capacity dispute. The next section discusses how each bank approached CPC's 'no capacity' defence.

Each of Deutsche Bank, Standard Chartered and Citibank approached the capacity problem differently. Deutsche Bank took its case to ICSID. It won on the novel question of whether derivatives were investments and in the affirmative, that CPC had capacity. Standard Chartered succeeded on the same capacity question with the Court of Appeal in *Standard Chartered CA*. Citibank launched proceedings in the LCIA and also contended that CPC had capacity. That argument was rejected, leading to failure in Citibank's claim ('*Citibank*').[38] Although both *Deutsche Bank* and *Standard Chartered CA* found that CPC had capacity, the problem is that the basis on which capacity was found differed. This was acknowledged in *Deutsche Bank*.[39] The arbitral tribunal in *Citibank* on the other hand found that CPC had no capacity. Despite the same set of facts, ICSID and the LCIA reached opposing conclusions in relation to capacity to enter derivatives and where capacity was found (in ICSID and the Court of Appeal), the basis on which it was found differed.

31 'Small' because the use of derivatives by public bodies is minimal compared to the notional amount of exposure by a diverse range of parties in the derivatives market, which stands at circa $715 trillion. See Bank of International Settlements, 'OTC derivative statistics at end-June 2023'.
32 *Deutsche Bank*, 6.
33 ibid 344.
34 *Standard Chartered (CA), Moore-Bick LJ*, [7].
35 *Deutsche Bank*, 9.
36 ibid.
37 See (n 16). Rivkin and Friedman review *Deutsche Bank* from an investment treaty law perspective.
38 Referred to in *Standard Chartered (CA)* (n 34) [9].
39 *Deutsche Bank*, 345.

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The above demonstrates that clear uncertainty exists. These conflicting decisions exacerbate the possibility of systemic risk actualizing in these markets through uncertainty. In this case, that could result in a greater cost of business (imposed by banks) for public bodies using derivatives for beneficial public reasons. Whilst the cases of *Deutsche Bank, Standard Chartered CA* and *Citibank* all involved the determination of private law rights in a contract, the important factor in these disputes is that this determination of capacity involving public bodies should be undertaken through a lens of systemic risk concerns. Following this, it is suggested that what is required is a 'balancing' act between legal doctrine and systemic risk. This is considered below.

Balancing systemic risk against legal doctrine

This section suggests that in light of (1) the exposure of public bodies to derivatives and (2) disputes as a source of systemic risk as outlined above, the determination of the capacity of public bodies to make valid derivative contracts requires a balance between legal principles and systemic risk. Systemic risk is the possibility of market failure through an aggregation of other risks.[40] Legal uncertainty counts as one of the potential sources of such risk materializing because a legal decision can impact the transactional validity of a wide range of market participants. The need for a balancing act is particularly relevant in the context of public bodies, as their public functions can be disrupted by their interaction with markets. The issue with public bodies, however, is that their disputes in derivatives are ultimately private matters of contract. In light of this, it is important that judges and tribunals recognize that the integrity of private law doctrines should be tempered against the public impact of those decisions for markets and by extension, the public. Clear examples that English judges think in this manner can be seen in two key cases in derivatives litigation. The first is *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch) ('*Lomas*') Here, Briggs J stated that the ISDA Master Agreement, the key documentation for OTC derivatives, is '*probably the most important standard market agreement used in the financial world*'.[41] Second, *In the matter of Lehman Brothers International (Europe) and in the matter of the Insolvency Act 1986* [2016] EWHC 2417 (Ch), Hilyard J stated that the issues raised in the case involving the ISDA Master Agreement were '*… not only substantial in terms of monetary value; they raise issues of systemic importance …*'[42] On this basis, even though judges may not adopt the terms '*public vs private*' or '*systemic risk*', the manner in which they seek to resolve these disputes demonstrates that English courts can manage the systemic risk issues that come about from the application of private law rules that impact public life. It is therefore important that courts and tribunals are market sensitive.

The term 'market sensitivity' was first, in the author's knowledge, mentioned by Professor Roger McCormick in an interview with Lord Woolf.[43] The term is adopted as a convenient way of saying that when a court or tribunal's decision has implications for financial markets, it is sensitive in that whether right or wrong, its result is being anticipated. Making these types of decisions requires a balance of sensitivity between private law and the public impact that arises from uncertainty in decisions about those private law issues. To this end, there has been some inconsistent treatment of capacity in derivatives. One example of this is courts speaking with different voices on whether the question of hedging vs speculation requires an objective or subjective test.[44] Similarly, the case of *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103 (Comm) ('*Credit Suisse*'), for example, shows that uncertainty exists with respect to the question of who bears the burden of proof and the difference between capacity of natural\legal persons.[45] The problem with legal uncertainty is that it serves as a potential source of systemic risk in an important financial market to which a range of public bodies are globally exposed. Briggs J in *Lomas*, for example, cites evidence from ISDA that over 90 per cent of OTC

[40] These include counterparty, liquidity and operational risks. Pawel Smaga, 'The Concept of Systemic Risk' (2014) LSE Systemic Risk Centre Special Paper No 5, 2.

[41] *Lomas*, Briggs J, [53]

[42] In the matter of Lehman Brothers International (Europe) and in the matter of the Insolvency Act 1986, [2016] EWHC 2417 (Ch), Hildyard J, [24].

[43] Interview with Lord Woolf, 'How the Financial Markets Law Committee Works and Why We Need It' (2007) 1 Law Fin Mar Rev 3.

[44] Simon Clarke, 'Smoothing out the rough hedges' (2017) 32 BJIB & FL 688.

[45] *Credit Suisse*, [186]–[187].

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derivatives are governed under the ISDA Master Agreement.[46] This acknowledgement is yet another example of the courts recognizing systemic risk, albeit without using the term. Taken together, these factors combine to make the impact of legal uncertainty significant.

The next part comprises a review of the legal principles that English courts have typically applied in finding capacity. These are the principles that courts have to interpret in a way that minimizes systemic risk. However, as demonstrated below, these principles have many iterations and will be dependent on the nature of the dispute and transactions within which they arise.

3. Capacity in English law

This section analyses the legal principles that guide courts in determination of capacity disputes. Most of these principles are drawn from determination of capacity with respect to English public bodies. The task of balancing unsettled principles against systemic risk is not an envious one. It involves an application of precedent which may never have been suited to financial markets in the first place. In a paper analysing English ultra vires cases from *Hazell* to the more recent cases, Braithwaite points out that the difficulties raised by capacity disputes are in constant conflict with the market-minded approach of the English courts.[47] This section develops this further in order to emphasize the point that these principles, unsettled as they are, must be balanced against systemic risk concerns.

Functions

First, determining capacity requires an assessment of the entity's function. This part of the law is relatively straightforward. English courts developed this approach in *Hazell (HOL)* which considered interpretation of the Local Government Act 1972. '*Functions*' was interpreted to mean all the duties and powers of the local authority. The Act did not include explicit powers to enter swaps, and it was not prohibited. This meant local authorities had no powers to enter into swaps with a view to using profits for legitimate functions under the Act. The important question was whether swap transactions '*facilitate*' or were '*conducive or incidental to*' the function of borrowing. Note that in *Hazell (HOL)*, this is the function that was relevant. But functions can encompass wider spheres of activity. Today, Section 12 of the Local Government Act 2003 gives a local authority explicit powers to invest: '(a) *for any purpose relevant to any of its functions under any enactment, or* (b) *for the purpose of the prudent management of its financial affairs*'. On this basis, investments fall within a function of the relevant public law entity. To fall within Section 12, however, derivative transactions should be associated with the investment functions of the local authority or public body.

The incidental

Second, capacity requires assessment of the incidental. This test brings with it some practical difficulty when applied to the derivatives market. In the UK, local authorities have capacity and competence to do anything: '*calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions*'.[48] Something is '*incidental to*' when it follows on from something else. Where a transaction is entered into to reduce or eliminate risk associated with an investment, that transaction is incidental to the making of the investment. Similarly, under Section 1(1) of the Localism Act 2011, a local authority has power to do anything that individuals generally may do unless it is subject to a limitation expressly imposed by a statutory provision.[49] This means its general power of competence is dependent on statutory limits. The application of '*incidental to*' is not straightforward when applied to the versatile use of derivatives. For example, if a public body enters into a derivative trade to swap its fixed interest rate loan obligations for floating interest rate loan obligations, with the intention of making a profit out of the movement of the underlying interest rate, that is a speculative investment. '*Incidental*' to that investment would be swapping its own floating interest rate loan obligations for fixed interest rate loan obligations, in order that it offsets its position under the initial swap and

[46] *Lomas*, Briggs J, [5].
[47] See Braithwaite (n 14) 21.
[48] Local Government Act 1972, s 111.
[49] Localism Act 2011, s 1(1).

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therefore is protected back-to-back. This depends on how the interest rate market moves in or out of its favour. By doing this, it has hedged its speculative investment under the initial swap. This subsequent hedge is what would be called '*incidental*' to the speculative investment. The question is then whether the speculative investment is within the legal limits of what the body has capacity to do. What remains unclear is whether the speculative investment can be considered '*incidental*' to the functions of the public body. There is no clear guidance on how to go about this, and it seems this is a question that courts resolve by referring to the documents that establish the entity, alongside the limits to the entity's activity. This was considered in *Hazell (HOL)*, where Lord Templeman held that the question was not whether swap transactions were incidental to borrowing but whether swap transactions were incidental to a local authority's borrowing function having regard to the provisions and limitations of the 1972 Act regulating that function.[50] From this, it will always be difficult for parties to tell beforehand whether a speculative investment, which is hedged, can itself be '*incidental*' to the body's function. The incidental point arose in another case: *Standard Chartered (CA)*, where the Court of Appeal held that derivative transactions (in the context of hedging transactions) were incidental or conducive to the public entity's objects of managing oil importation. This clarifies that arguments that derivative transactions are not incidental or conducive to objects are likely to fail, but it does not clarify whether a speculative investment which is hedged can be deemed '*incidental*'. The practical and most important point is to clearly identify the function for which the public body was established, alongside limits to that function. From this, a court can subsequently determine whether the derivative transaction is incidental or conducive to the identified function. The status of a speculative investment which is subsequently hedged, however, remains unclear in terms of its effect on the function of the relevant public body.

Investments

Third, the question of whether the derivative trade is an '*investment*' is important in finding capacity. The power of local authorities to invest under English law is covered by Section 12 of the Local Government Act 2003. This test contains practical difficulties because the Local Government Act 2003 and the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ('2009 Regulations')—governing the power of a local authority to invest for pension purposes, did not contain definitions of these terms. They offered some guidance by stating that '*investment*' and similar expressions have their normal meaning.[51] The revised regulations have now removed the ambiguity by stating in the definition of investment: '*a contract entered into in the course of dealing in financial futures, traded options or derivatives is an investment*'.[52] This is nevertheless a vague area of law because there is little authority that courts think of all types of derivatives in this manner. This means the versatility of derivatives reflected in the potential combination of products makes interpreting a contract along these lines difficult. The purchase, for example, of foreign currency where the purpose is to benefit from an appreciation in value, would count as an investment. The problem with this is that it conflates the making of an investment with speculation. It is the author's view that the buying of any derivative contract is an investment. In the context of public bodies, the general power to invest means the derivative bought could be speculative or hedging. It is on this basis that it is safer to conclude that derivatives constitute investments in a general sense, whether they be speculative or hedging. This broader understanding of investments is supported by the fact that swaps are regulated as investments under Section 3 (Specified Investments) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The important thing for a public body then is that it must have the power to invest in financial market instruments first. The question of whether that investment is within its capacity is a secondary question that may be answered by reference to substantively determining whether it is a speculative or hedging trade.

Foreign element

There have been a significant number of capacity cases which involve foreign public bodies. This foreign element results in the widening of claims that are brought in connection with a capacity

[50] *Hazell (HOL)*, Lord Templeman, [30].
[51] 2009 Regulations 3 (1).
[52] ibid.

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dispute. First, there is the question of which law applies. The general rule is that matters of capacity fall within the jurisdiction of the country where the body is incorporated or constituted. With respect to substantive law, the local law of the public law entity decides the question as to whether that authority has capacity, but the law applicable to the contract determines the consequence of capacity.[53] Second, the foreign element to capacity disputes is a new phenomenon. As Braithwaite points out, a significant amount of case law now diverges from the *Hazell (HOL)* era, with most involving preliminary questions on jurisdiction.[54] Aikens LJ mentions this in *JP Morgan v Berliner Verkehrsbetriebe (BVG) Anstalt des Öffentlichen Rechts*, [2010] EWCA Civ 390, where he states that the first battle is over jurisdiction.[55] Braithwaite continues that this helps to generate new legal issues around jurisdiction and applicable law, while at the same time complicating the above capacity questions and resulting claims.[56] The importance of the foreign element to capacity disputes was recently considered in the case of *Comune Di Busto Arsizio*. In that case, Cockerill J noted that it was open to an English judge to diverge from the highest authority, particularly in the context of a civilian law system, if on the evidence, the judge can be satisfied that an authority does not represent the law.[57] Whilst the English courts have done an excellent job of navigating these cross-jurisdictional difficulties, the law is still unclear in many areas of practical and legal importance. This review nonetheless serves as the foundation for engaging with the complicated question of whether a public body is hedging or speculating in derivatives below.

4. Distinguishing between Hedging and Speculation

This section explores how the English courts have approached the question of whether a public entity is hedging or speculating through derivatives. The link between the rules on capacity in Section 3 and this distinction can be outlined as follows. Capacity reflects the status of the public body to contract. The rules discussed above are the relevant pillars used by the courts in finding that status. The distinction between hedging and speculation, on the other hand, reflects the limits on market activity for the relevant public body. In the case of public bodies and as Ross points out, the limit on capacity is usually the restriction that transactions are not speculative.[58] It should be emphasized that there is nothing wrong with speculation. This is clear from the above analysis of how courts should determine whether a derivative is an '*investment*'. The term '*investment*' can apply to hedging or speculation. It is simply the policy position that speculation is usually prohibited, even within the context of what is otherwise considered an investment. If permitted, it would need to be stated or implied in the instrument establishing or regulating the body that speculation is permissible. This would in turn give the public body capacity in the strict legal sense. Following this, Section 4 proceeds as follows. Section 'Hedging and speculation' outlines the conceptual difference between hedging and speculation. Section 'Reluctance as the dominant approach' outlines the reluctance of the courts to distinguish between hedging and speculation. Section 'Analysis of the reluctance to distinguish between hedging and speculation' offers an analysis of the reluctance.

Hedging and speculation

This section briefly outlines the conceptual difference between hedging and speculation. The wide use of derivatives reflected in their versatility as hedging and speculative products in financial markets is what makes the legal question of capacity difficult. One tension is the interaction between these transactions in the private sector and accountability of the public body in the specific event that loss is incurred through what was otherwise intended to be a risk management mechanism. Whether or not a public entity is doing one or the other will depend on the relevant facts of the situation. First, hedging is a defensive function used in the management of financial

53 *Depfa*, Aikens LJ, [60].
54 See Braithwaite (n 14) 17.
55 *BVG*, Aikens LJ, [1].
56 See Braithwaite (n 14) 18.
57 *Comune Di Busto Arsizio*, Flaux LJ, [108].
58 Jonathan Ross, 'The Case for P.R.I.M.E. Finance: P.R.I.M.E. Finance cases' (2012) 7 Cap Mark Law J 233.

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risk.[59] Hedging provides protection from losses attributable to changes in market conditions.[60] In this situation, risk-averse investors want protection of their trading position. Leaving derivatives, they can hedge by holding two or more assets whose risk/return characteristics offset one another. The derivatives market, however, provides a more precise way of doing this. Benjamin points out that hedging transfers risks away from a protection buyer to a financial institution acting as protection provider.[61] Hedging may be required to protect an exporter with euro income and sterling expenses from a drop in the value of the euro. This may be hedged through currency swaps, for example.[62] Hedging takes away the risks associated with a financial position, as well as the speculative profit that could have been derived from the difference in prices. Second, speculation. A speculator trades with a view to making a profit. This requires outguessing the market as to changes in market conditions.[63] A typical speculator is prepared to outlay larger amounts of money on a trade because they believe they know which way prices will move. The hedger, on the other hand, hedges to address risks associated with that asset.[64] The speculator is only concerned about the difference between the price of the asset daily, hourly or even within a second. This is typical of hedge funds, for example. It is important to note that an entity with market risks can fail to hedge their risks. It is correct to assume that this may amount to speculation if they have the means to hedge the risk and choose not to do so. The next section outlines how the courts have been reluctant to delve into the conceptual differences outlined above.

Reluctance as the dominant approach

The reluctance of English courts to consider the difference between hedging and speculation emanates from the *Hazell (HOL)* judgement. The Divisional Court had held that power to undertake business of trading interest rate swaps for speculative purposes did not exist.[65] In considering the difference between hedging and speculation, the Court of Appeal agreed and held that clear links between the derivative and investment hedged had to be demonstrated.[66] Lord Templeman in *Hazell (HOL)* disagreed. He observed that the parallel swap doctrine developed by the Court of Appeal lacked definition.[67] This reluctance continued in *Banco Santander Totta SA v Companhia De Carris De Ferro De Lisboa AS* [2016] 4 WLR 49 ('*Banco Santander Totta*'), where Blair J held that definitions of '*speculative*' or a '*speculator*' did not exist.[68] Likewise, in the High Court judgement of *Standard Chartered (HC)*, Hamblem J weighed factors indicative of hedging and speculation in the balance before concluding that a blurred line existed between the concepts.[69] This was followed in the Court of Appeal.[70] Following the analysis of what may be '*incidental*' to a public body's functions, Moore-Bick LJ in *Standard Chartered (CA)* observed that it was not surprising that the public body in that case (CPC) had always accepted that it had capacity because the oil-derivative contracts were transactions that may be properly regarded as incidental or conducive to CPC's role or function in oil importation.[71] This reluctance is followed in the academic commentary. In this respect, McKendrick questioned the utility of the distinction.[72] Clarke also suggested that hedging and speculation should be assessed along a spectrum and not seen as a dichotomy.[73] This received tacit endorsement in *Credit Suisse*, where Credit Suisse argued that the distinction drawn by the public law entity between hedging and speculative transactions was of little value, with Andrew Smith J calling it elusive.[74]

59 See Benjamin (n 2) 87.
60 This comprises changes in asset prices, interest rates, currency values and any risk an entity is exposed to.
61 See Benjamin (n 2) 87.
62 ibid.
63 ibid.
64 ibid.
65 See *Standard Chartered (CA)* (n 34) [779].
66 ibid [784].
67 *Hazell (HOL)*, [27].
68 *Banco Santander Totta*, Blair J, [444].
69 *Standard Chartered (HC)*, see (n 30) [340].[AQ]
70 *Standard Chartered (CA)* (n 34) [14]–[16].
71 ibid [33].
72 In context of discussing the Court of Appeal's approach in *Hazell (HOL)*, see Mckendrick (n 15) 212–3.
73 Simon Clarke, 'Smoothing out the Rough Hedges' (2017) 32 BJIB & FL 688, 6.
74 *Credit Suisse*, Andrew Smith J [214].

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Braithwaite also argues that 'hedging' as a shorthand for 'valid under the applicable rules providing for capacity' is not helpful because it attributes too much weight to uncertain labels, thereby opening new questions for experts and courts.[75] Following this, Braithwaite refers to the 'capacity-led' approach in *Banco Santander Totta*, where Blair J refused to define the purpose of particular products[76], as more valuable.[77] On this basis, it has been suggested that litigants avoid characterizing the issues in terms of hedging and speculation, and where possible, the courts should decline invitations to evaluate capacity in this manner.[78] It is worth analysing this reluctance to consider whether it is justified.

Analysis of the reluctance to distinguish between hedging and speculation

The reluctance to distinguish between hedging and speculation can be challenged on the following grounds. First, the Court of Appeal's reluctance in *Standard Chartered (CA)* to distinguish between the concepts is not instructive in a situation where parties are agreed that capacity does not exist for speculation. The parties can reach this agreement and adopt a definition of what speculation is, even if there is a subsequent argument as to what a hedge is. Take *Deutsche Bank* for example. A first reading of CPC's objects looks like it had capacity to contract for any purpose.[79] However, after considering its hedging program, it became clear that it only had capacity to hedge, thereby necessitating an analysis of what a hedge was. This approach can be located squarely within the English law principle that capacity can be founded on the basis of it being '*incidental*' to the entity's functions and this approach is followed in *Deutsche Bank*.[80] If that entity's function is to make particular investments, which require a hedge, then it has capacity. In most cases, the relevant entity's function will not allow speculative transactions that have no connection to lawful investments. This is what necessitates an assessment of the difference between the two concepts. This is supported by *Deutsche Bank* where the ICSID Tribunal points out that it had reached its conclusion on the basis of CPC's position that it did not have capacity to speculate.[81] The terms 'hedging' and 'speculation' do not have to be divisive,[82] in the event that the parties agree as to what they mean in the context of their trading relationship.

Credit Suisse is also instructive in demonstrating the objectivity of distinguishing between the two concepts. Andrew Smith J concluded that the experts agreed in their joint memorandum that hedging describes the activity that a counterparty undertakes to reduce exposure to market risks.[83] On this basis, Andrew Smith J specifies what is meant by hedging in the particular context of the transaction that was disputed.[84] In doing this, the judge was able to acknowledge that it was possible to describe a decision to hedge as a speculation.[85] This problem was eliminated in *Credit Suisse* because under Dutch law, the public entity had capacity to make hedging transactions because they were conducive to their main objects. Andrew Smith J considered it readily understandable that therefore it would be within their capacity to hedge against risks arising from the carrying out of the main objects. This led to a clear need to make a distinction between speculation and hedging. In this respect, Andrew J Smith states that an obvious example of a hedge is a transaction against the risks from a mismatch between borrowings required to provide housing, which might well be at floating rates of interest, and rental income, which typically does not fluctuate correspondingly but is broadly fixed in nature.[86] This means anything unconnected to their main objects is not within capacity, as it would be speculative. This approach directly mirrors the approach in *Deutsche Bank*, as the hedge had to be connected to the investment in a substantial way, similar to the Court of Appeal's view in *Hazell (COA)*. This position is further supported with *Banco Santander Totta*, where although it was held that the differences

[75] See Braithwaite (n 14) 21.
[76] *Banco Santander Totta*, Blair J, [322].
[77] See Braithwaite (n 14) 21.
[78] ibid.
[79] *Deutsche Bank*, 13.
[80] ibid 321.
[81] ibid 345.
[82] See Braithwaite (n 14) 21.
[83] *Credit Suisse*, Andrew Smith J, [225].
[84] ibid [217].
[85] ibid [218].
[86] ibid.

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between hedging and speculation were blurred, it was held that this was the case only when there was no applicable definition.[87]

One criticism of this approach is that it is not practical, since the investment bank brokering the trade for the public body may not have a good view of their client public body's entire portfolio. This may include trades with other banks and risks that may not correspond to the client's current investment strategy. This criticism does not hold for the following reason. The post—*Hazell (HOL)* case law tells us that derivatives with public bodies may be invalid on capacity grounds. On this basis, one may contend that before banks enter into these trades (armed with the knowledge that derivatives may be invalid on capacity grounds) they already undertake stringent due diligence which would reveal whether a public body is hedging or speculating and whether capacity exists for the particular trade. This may be countered by suggesting that banks will miss out on business. This would not hold because the consequences of incapacity are likely to be worse than the business lost. It is more reasonable that banks will be more stringent and price in the risk of incapacity into the relevant derivative trade.

Second, the approach in *Banco Santander Totta*, much like the Court of Appeal in *Standard Chartered (CA)* is only one way of determining capacity. Another way is the Tribunal's approach in *Deutsche Bank* and *Credit Suisse*. The *Standard Chartered (CA)* case is accompanied by other proceedings which concern the same facts, so it would be incorrect to accept it as the only approach. Application of *Standard Chartered (CA)* to future disputes should therefore take into account the *Deutsche Bank* and *Citibank* cases which both involve determination of the same entity's capacity—CPC. Franks posits that *Standard Chartered (CA)* marks an end of an era where lingering doubts were left by the House of Lords in *Hazell (HOL)*.[88] Whilst it is acknowledged that *Standard Chartered (CA)* demonstrates a viable approach to capacity, there is an arguably better approach, and it requires judicial engagement with the difficulties inherent in distinguishing between hedging and speculation. This is considered in more depth below.

5. Engaging with the Hedging or Speculation Question

Section 4 has contended that there is a clear judicial reluctance to make the distinction between hedging and speculation in determination of capacity. The solution proffered in this section is to engage with the distinction. The *Deutsche Bank* case is an Arbitral Award. Its precedential effect in English law is therefore limited. It, however, has a close counterpart—The *Credit Suisse* case. This is followed by the more recent decision of the Court of Appeal in *Comune Di Venezia*. Following this, this section proceeds in four steps. First, Section 'Agreement on speculation' emphasizes the importance of agreement as to what speculation is. Second, Section 'Objective test' suggests that once agreement is established that a prohibition on speculation exists in the relevant circumstances, it follows that an objective test will assist in revealing whether a hedge has occurred. Third, Sections 'Application of the objective test: Comune Di Venezia' and 'Insights from Comune Di Venezia' consider the new insights that can be drawn from the recent determination of the capacity of an Italian public body in *Comune di Venezia*.

Agreement on speculation

The first step to engaging with the distinction between hedging and speculation is a search for the parties' agreement on what speculation is. An agreed factual determination of what the relevant entity can or cannot do allows the relevant court or tribunal to analyse the specific requirements of a hedge in the context of what the transaction is intended to achieve. A hedge against borrowing costs (as in *Hazell (HOL)*) is necessarily different from a hedge against the price of a commodity (as in *Deutsche Bank*). In *Deutsche Bank*, CPC argued that the transactions amounted to speculation and, in this respect, it had no capacity.[89] The importance of this argument is that it gave the Tribunal a starting point. The court or tribunal (armed with the parties' agreement on what it is they cannot do) can then determine what has in fact been done. In *Deutsche Bank*, this meant the Tribunal had to consider the requirements of hedging. Whereas the Court of Appeal in *Standard*

[87] *Banco Santander Totta*, Blair J at [444].
[88] See (n 13).
[89] *Deutsche Bank*, 323.

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Chartered (CA) refused to do this, the Tribunal in *Deutsche Bank*, correctly, tackled the difficult question of what constituted a hedge in the context of the parties' agreement on what speculation was. This is replicated in *Credit Suisse*, where Andrew Smith J considered all the transactions in order to provide an answer to the question of whether each was a hedge or speculation.[90]

It is important to point out that Andrew Smith J in *Credit Suisse* and the Tribunal in *Deutsche Bank* were heavily assisted by expert witnesses. This is one of the most important lessons from these cases. The use of expert witnesses is something that actively enhances a court or tribunal's decision when it has to consider the capacity of a public body to trade derivatives, as well as the vires of the transaction. In reaching the decision that the difference between hedging and speculation required the use of an objective test, the expert witness was determinative to the Tribunal in *Deutsche Bank* reaching a market sensitive outcome. There was use of expert witnesses in *Standard Chartered (CA)* and *Credit Suisse*. However, the greater flexibility provided by arbitration allows the experts to have a greater impact. Evidence for this position is seen in *Deutsche Bank* in two respects. First, the Tribunal affirmed the experts' agreement that a hedge had to be risk reducing.[91] A parallel of this is seen in *Credit Suisse*, with Andrew Smith J describing instruments that would constitute hedges.[92] Second, the Tribunal decided as to the nature of risk reduction required.[93] This area of disagreement is where the expert reports effectively decided the outcome in the case. The expert for Deutsche Bank contended that if a transaction reduces risk, it is hedging, and if it increases risk, it is speculation. The Deutsche Bank expert's contention was that this judgment should be made objectively and that subjective issues (ie intention) should not be taken into account. On the other hand, the expert for Sri Lanka/CPC contended that something more was required to constitute a hedge.[94] The Tribunal was not convinced by this.[95] This is because, as the Tribunal pointed out, the addition of a '*meaningfulness*' or '*effectiveness*' requirement is deeply subjective and could mean many things to many people.[96] The Tribunal went further by pointing out that if the distinction between hedging and speculation was subjective, CPC could never be sure whether it had capacity or not to enter into what it considered to be a 'hedging' transaction. This necessitates a return to an objective test.

Objective test

This section asserts that the correct approach to distinguishing between hedging and speculation is an objective one. This approach finds support in *Credit Suisse*. The Court of Appeal in *Standard Chartered (CA)* was troubled by the distinction being decided objectively.[97] *Credit Suisse*, however, shows that the test can be objective. With respect to hedging and speculation, the Court in *Credit Suisse* held that certain derivatives were regarded as hedging transactions, whilst others were not.[98] This approach is consistent with *Deutsche Bank*, as the Tribunal concluded that CPC had not convinced the Tribunal that the hedging transactions were speculative.[99] The transactions were conducive or incidental to CPC's business. This approach to capacity mirrors *Credit Suisse* in its acceptance that one can distinguish between hedging and speculation. This approach further tallies with the English law approach of determining the general powers of an authority and seeking to establish capacity through its competence and function, as well as what is conducive or incidental to its objects, as outlined in Section 3. The objective test is also beneficial because of the regulatory context in which derivatives sit.[100] Courts, tribunals and expert witnesses have a role to play in facilitating stability of the derivative market. This is pointed out by Braithwaite who highlights the risks of circumventing the judiciary in the context of ongoing OTC derivatives reform, as courts have more extensive roles to

90 *Credit Suisse*, Andrew Smith J, [228]–[253].
91 *Deutsche Bank*, 331.
92 *Credit Suisse*, Andrew Smith J, [217]–[221].
93 ibid.
94 *Deutsche Bank*, 332.
95 ibid 333.
96 ibid 334
97 *Standard Chartered (CA)* (n 34) [16].
98 *Credit Suisse*, Andrew Smith J, [232]–[241].
99 *Deutsche Bank*, 347.
100 European Market Infrastructure Regulation ('EMIR') and EU/US Margin Rules are examples of key regulatory changes, governing clearing and collateralization in derivative markets.

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play within the derivative market.[101] Consequently, if participants know that courts have specific ways of determining the distinction objectively, this assists in achieving market stability and minimizes systemic risk. This objective test is further supported by the *Comune di Venezia* case, which is discussed below.

Application of the objective test: *Comune Di Venezia*

In *Comune Di Venezia*, the Court of Appeal allowed an appeal against the finding of the High Court that interest-rate swaps ('IRS') were impermissible speculation contrary to Article 119(6) of the Italian Constitution.[102] The City of Venice issued a 20-year Euribor-linked floating rate bond (the '*Rialto Bond*') maturing in 2022.[103] At around the same time, Venice entered into a swap with Bear Stears under which Venice would receive the floating Euribor-linked rate and pay a USD-Libor-linked floating rate with a cap and floor (known as a 'collar') (the '*Bear Stearns Swap*').[104] Venice decided to restructure the *Rialto Bond*, extending its maturity to 2037 and varying its coupon.[105] This became known as the '*Amended Rialto Bond*'.[106] Due to the restructuring, the terms of the *Bear Stearns Swap* were no longer aligned with Venice's exposure to interest rate risk under the now *Amended Rialto Bond*.[107] Bear Stearns was not willing to amend the *Bear Stearns Swap*, so Venice agreed to a restructuring with a number of new banks which took the following form.

First, Bear Stearns, the new banks and Venice entered into novations under which 68 per cent of the notional amount of the *Bear Stearns Swap* was novated to Banca Intesa in return for a fee.[108] Second, 32 per cent of the notional amount of the *Bear Stearns Swap* was novated to Dexia also in return for a fee.[109] The fees reflected the value to Bear Stearns (ie the negative mark to market ('MTM') in its favour) of the *Bear Stearns Swap*.[110] Since the terms of the *Bear Stearns Swap* were not aligned with the *Amended Rialto Bond*, the existing swap as novated needed to be restructured.[111] Under the transactions with the new banks, they and Venice agreed a new collar IRS with an extended maturity date matching the *Amended Rialto Bond*, under which Venice benefitted from a cap on the variable rate that was payable under the *Amended Rialto Bond*. Venice also agreed to pay a fixed rate if the variable rate fell below a particular floor.[112] Unlike the *Bear Stearns Swap*, the terms of the transactions with the new banks matched the *Amended Rialto Bond*.[113] However, as would have been the case with any renegotiation between swap counterparties of an existing IRS transaction, the terms of the transactions reflected the existing negative MTM (to Venice) of the novated amounts of the *Bear Stearns Swap*.[114]

As outlined in the introduction to this article, the important context of public policy was highly relevant to the determination of whether these complex transactions were permissible risk-management tools in *Comune di Venezia*. The dispute began in 2008 when Venice received a letter from the President of the VIII Commission of the City Council of Venice querying whether the transactions described above were binding and/or could be cancelled on the grounds that they were speculative.[115] Whilst Venice did not seek to dispute the validity of the transactions in 2008, in 2019, it commenced proceedings against the new banks in Italy claiming damages for breach of contractual and non-contractual advisory duties in relation to the transactions.[116] In 2019, the new banks commenced proceedings in the English High Court seeking declarations that the transactions were valid and binding.[117] Then, on 12 May 2020, the

[101] Jo Braithwaite, 'OTC Derivatives, the Courts and Regulatory Reform' (2012) 7 Cap Mark Law J 364, with 373 discussing the risks.
[102] *Comune Di Venezia*, [175].
[103] ibid [5].
[104] ibid.
[105] *Comune Di Venezia*, Flaux LJ, [6].
[106] ibid.
[107] ibid.
[108] ibid.
[109] ibid.
[110] ibid.
[111] *Comune Di Venezia*, Flaux LJ, [7].
[112] ibid.
[113] ibid.
[114] ibid.
[115] *Comune Di Venezia*, Flaux LJ, [9].
[116] ibid [11].
[117] ibid.

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Joint Sections of the Italian Supreme Court of Cassation issued the *Cattolica* decision holding that for the purposes of Italian law, a local authority did not have capacity to enter into speculative derivatives and that certain types of swaps could constitute indebtedness under Italian law.[118] Following the decision of Foxton J in the High Court,[119] Venice appealed to the Court of Appeal on grounds of the relevant law applicable to their claim for restitution[120] and the application of a change of position to any payments under their swaps with the banks.[121]

Insights from *Comune Di Venezia*

The case of *Comune Di Venezia* provides three important insights which demonstrate the necessity of objectively distinguishing between the concepts of hedging and speculation in determining the capacity of a public body to enter derivative contracts. Whilst the case raises a number of interesting points on restitution and conflict of laws, these are not addressed here. Rather, the focus is on Flaux LJ's holding that rolling over the negative MTM in the context of restructuring a derivative did not amount to speculation.[122] This is considered in three respects below.

First, the objective test outlined in Section 'Application of the objective test: Comune Di Venezia' is reflected in the Court's finding that the disputed swap in *Comune di Venezia* was a valid hedge. This determination can only be undertaken objectively. In Flaux LJ's judgment, the fact that the *Bear Stearns Swap* was a hedge and therefore valid, meant that the Italian Supreme Court would have concluded on the same lines.[123] This is because the *Bear Stearns Swap* gave Venice the benefit of an extended maturity period and other terms to correlate with the *Amended Rialto Bond*, without altering the economic effect of the *Bear Stearns Swap*.[124] On this basis, there was no reason to conclude that the transactions were anything other than hedging transactions. It was on this basis that the appeal succeeded.[125] To reach this conclusion, it was important to analyse the transactions objectively. The question was whether the transactions were speculative in line with the prohibition by Article 119(6) of the Italian constitution. The approach of Flaux LJ corresponds to the point made in Section 'Objective test'. This approach properly considers what a speculation is and analyses the transactions in direct light of what is prohibited, that is, the definition of speculation and indebtedness under Article 119(6) of the Italian Constitution. Following this, Flaux LJ determined that they were hedges.

Second, the restructuring of a derivative position does not necessarily amount to speculation. This particular point is important to analysing what a hedge is. This is because a participant may indeed restructure an initially hedging derivative trade to be speculative in its risk profile. It can also restructure an initially hedging derivative trade to ensure it continues to serve a hedging purpose, as was done in *Comune di Venezia*. However, the important criterion to look at is the substantive effect of any restructuring or subsequent trades which might affect the initial transactions. Flaux LJ noted that at the time when Venice restructured the *Rialto Bond*, because of the new terms and extended maturity date, Venice needed to renegotiate and restructure the *Bear Stearns Swap* to bring it into alignment with the *Amended Rialto Bond* or enter into a new swap with banks which aligned with the *Amended Rialto Bond*.[126] Had Bear Stearns agreed to restructure its swap, it would be absurd, Flaux LJ continued, to suggest that Italian law would have prohibited the restructuring of the *Rialto Bond* and the hedging swap.[127]

Third, in determining what a public body is doing with a derivative, it remains critical that this is considered in light of the exposure being held by the public body. This point is similar to the above, in that it continues to emphasize the need to determine, wholistically, what the effect of subsequent transactions are. It is, however, a different point because it speaks to exposure. A restructuring of a derivative consists of a rearrangement of its economic features, while transactions which hedge pre-existing exposure can range from simple derivatives to structured

[118] *Comune Di Venezia*, Flaux LJ, [12].
[119] *Banca Intesa Sanpaolo Spa & Anor v Comune Di V*enezia [2022] EWHC 2586.
[120] *Comune Di Venezia*, Flaux LJ, [59].
[121] ibid.
[122] *Comune Di Venezia*, Flaux LJ, [151]–[175].
[123] ibid [168].
[124] ibid.
[125] ibid.
[126] *Comune Di Venezia*, Flaux LJ, [157].
[127] ibid.

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products. This ultimately depends on the type of exposure and a decision by the hedging counterparty to choose which derivative product best suits it's desire to achieve an effective hedge. In *Comune di Venezia* and because Bear Stearns would not renegotiate its swap, Venice had to approach other banks, since Venice was not willing to pay cash to cancel out the *Bear Stearns Swap*.[128] Because the *Bear Stearns Swap*, as novated to the banks was not aligned with the *Amended Rialto Bond*, it needed to be restructured, hence the entering of the new swaps with the banks, with an extended maturity date matching that of the *Amended Rialto Bond* and a cap on the variable rate of interest payable under the *Amended Rialto Bond*.[129] Contrary to Foxton J's conclusion, the negative MTM was an existing exposure of Venice originally to Bear Stearns, now to the banks.[130] If that existing exposure had remained to Bear Stearns, it would not have converted a valid hedging swap into something speculative when the swap was restructured.[131]

6. Conclusion

This article shows that the distinction between hedging and speculation in derivative transactions is a cornerstone test in balancing the engagement of public bodies in derivative markets with the necessary legal certainty that contributes to a minimization of systemic risk. Whilst the English courts have sometimes been reluctant to engage with the distinction, the article demonstrates various pockets within the case-law where this analysis takes place. This involves a delicate balance between upholding the legal doctrines discussed in Section 3 and addressing the realities of financial risk-management by public bodies. Within this, the importance of an objective test is critical. This test ensures that determinations are based not on subjective intentions but on the substantive effects and purposes of these transactions, as recently demonstrated in *Comune Di Venezia*. In light of their significant exposure to financial markets outlined in Section 'Exposure of public bodies', the objective criterion developed in Part V fosters predictability and consistency in judicial decisions, which remains crucial for the systemic risk implications of derivative market activity involving public bodies.

128 *Comune Di Venezia*, Flaux LJ, [158].
129 ibid.
130 ibid.
131 ibid.

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