FINANCIAL MARKETS LAW COMMITTEE

THE OBLIGATIONS OF CENTRAL COUNTERPARTIES AND THEIR CLEARING MEMBERS UNDER PART VII COMPANIES ACT 1989

Issues of legal uncertainty which may arise in the context of proprietary claims to collateral

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1. INTRODUCTION

Preface

1.1 The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 This paper addresses the uncertainty that would be caused by a proprietary challenge to the default management processes of a central clearing counterparty ("**CCP**") and by a third party claim on margin in these circumstances. In particular, the sections below identify issues affecting the system of protections for central clearing established under Part VII of the Companies Act 1989 ("**Part VII**") and related E.U. and U.K. regulation. The issues identified principally concern, or arise in the context of, (i) the protection for a CCP without actual notice of third party interests; (ii) the definition of "margin" in section 177 of the 1989 Act; (iii) the use of client trust acknowledgement letters; (iv) the practical steps typically taken by a clearing member ("**CM**") to protect itself from becoming unhedged on the default of a client; and (v) the exercise of termination rights by clients.

Background

1.3 The legal protections referred to above may be critically at issue in the event of a bankruptcy event of default on the part of a CM or a client. In either of these situations, the rules and default management processes of a CCP are designed to meet certain regulatory objectives and requirements, including the reduction of systemic risk and the implementation of safeguards for (non-defaulting) clients. Where applicable, they are also designed to accommodate actions taken by CMs to protect indirect clients in the event of a client default and to protect themselves from the risks posed by a defaulting client. Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") sets out the following among its regulatory objectives: "improving transparency in the derivatives markets" (Recital 7; see also Recital 6); "mitigating systemic risk" (Recital 7; see also Recitals 8, 15 and 21); "the mitigation of counterparty credit risk" (Recital 9); achieving "a high level of investor protection" (Recital 14); and creating access to clearing for investors, whether "as clients or indirect clients" (Recital 33).

1.4 Pursuant to these latter two objectives, EMIR and a subsequent Level 2 implementing regulation—Commission Delegated Regulation (EU) No 149/2013 (the "**EMIR Level 2 Regulation**")—impose a number of requirements in respect of default management processes designed to protect clients and indirect clients, including:

(a) a requirement for CCPs to enter into contractual commitments to trigger, in the event of a CM default, certain transfer procedures, commonly referred to as "**porting**", in relation to client assets and positions;[2]

(b) a requirement for CCPs to make "**leapfrog payments**" (subject to certain exceptions) to the clients of a defaulting CM in relation to any balance owed by the CCP after completion of its default management process;[3]

(c) a requirement for CMs to manage the default of a client by applying robust procedures for porting the assets and positions of indirect clients to another client;[4] and

(d) a requirement for CMs, in the alternative, to manage the default of a client by liquidating the assets and positions of indirect clients and by making leapfrog payments to those indirect clients in relation to any balance.[5]

1.5 These requirements have been the subject of two previous papers published by the FMLC: in October 2015 (the "**October 2015 Paper**") and in December 2015 (the "**December 2015**

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2 Article 48(5) of EMIR, concerning omnibus client segregation, provides:

> [w]here assets and positions are recorded in the records and accounts of a CCP as being held for the account of a defaulting clearing member's clients in [omnibus client segregation structures], the CCP shall, at least, contractually commit itself to trigger the procedures for the transfer of the assets and positions held by the defaulting clearing member for the account of its clients to another clearing member designated by all of those clients, on their request and without the consent of the defaulting clearing member. That other clearing member shall be obliged to accept those assets and positions only where it has previously entered into a contractual relationship with the clients by which it has committed itself to do so. If the transfer to that other clearing member has not taken place for any reason within a predefined transfer period specified in its operating rules, the CCP may take all steps permitted by its rules to actively manage its risks in relation to those positions, including liquidating the assets and positions held by the defaulting clearing member for the account of its clients.

Article 48(6), concerning individual client segregation, is drafted in similar terms.

3 Article 48(7) of EMIR provides:

> [c]lients' collateral distinguished in accordance with Article 39(2) and (3) [omnibus client segregation and individual client segregation structures] shall be used exclusively to cover the positions held for their account. Any balance owed by the CCP after the completion of the clearing member's default management process by the CCP shall be readily returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of its clients.

4 Article 4(4) of the EMIR Level 2 Regulation provides:

> [a] clearing member shall establish robust procedures to manage the default of a client that provides indirect clearing services. These procedures shall include a credible mechanism for transferring the positions and assets to an alternative client or clearing member, subject to the agreement of the indirect clients affected. A client or clearing member shall not be obliged to accept these positions unless it has entered into a prior contractual agreement to do so.

5 Article 4(5) of the EMIR Level 2 Regulation provides:

> [t]he clearing member shall also ensure that its procedures allow for the prompt liquidation of the assets and positions of indirect clients and the clearing member to pay all monies due to the indirect clients following the default of the client.

Paper").[6] The issues identified by the FMLC in those papers were analysed in the context of E.U. legislative provision for indirect clearing under the Markets in Financial Instruments Directive (2014/65/EU) ("**MiFID II**") and Regulation (EU) 600/2014 on Markets in Financial Instruments ("**MiFIR**"), as well as under EMIR.

1.6 The October 2015 and December 2015 papers addressed, in part, concerns that the E.U. rules on porting and leapfrog payments could conflict with the national insolvency laws of Member States—including those, say, prohibiting the preferential treatment of creditors or preventing an entity from surrendering assets on its own insolvency—and the FMLC briefly examined whether the drafting of EMIR and the EMIR Level 2 Regulation had done enough to ensure the overriding status of E.U. law in this regard.[7] In the U.K., at least, the uncertainty has been largely resolved by revisions to section 159 of the 1989 Act (*Proceedings of exchange or clearing house take precedence over insolvency procedures*), and in particular to sub-section (1), where amendments are designed to ensure that transfers pursuant to requirements on porting and leapfrog payments shall not "be regarded as to any extent invalid at law on the ground of inconsistency with [insolvency law]".

1.7 This paper further examines the question of the default management processes implemented by CCPs and CMs in an insolvency context but the issues addressed primarily concern the potential conflict between the relevant E.U. or U.K. law and regulation on clearing, on the one hand, and the property law of England and Wales, on the other.

1.8 If a client can argue that it has beneficial title to collateral in a CM's proprietary accounts when the latter defaults, a proprietary claim by the client may disrupt the application of the CCP's established default processes and derail the smooth operation of the CCP. It is this situation—and the client's claim that a title transfer collateral arrangement should be recharacterised by the court as a security collateral arrangement—which gave rise to a dispute between two group companies and the intervention of UK CCPs in *Re MF Global UK Ltd [2012] EWHC 3415 (Ch)*.[8]

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6 The October 2015 Paper (*ibid*.) responds to Consultation 2014/1570 by the European Securities and Markets Authority ("**ESMA**") and is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_indirect_clearing.pdf.

The December 2015 Paper (*ibid*.) reviews a re-draft of the consultative regulatory standards for indirect clearing set in Annex IV to the ESMA Consultation 2015/1628 and is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_indirect_clearing__december_2015_.pdf .

7 Recital 64 of EMIR provides that:

> [t]he requirements laid down in this Regulation on the segregation and portability of clients' positions and assets should… prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them.

Since recitals are not binding but merely demonstrative of the legislature's interpretation of principles, it is not wholly clear—as the FMLC briefly noted in the October 2015 Paper—whether a recital can override Member States' insolvency law. (See the general discussion at section 4 and, in particular, paragraph 4.4.)

8 The issue arose in *Re MF Global UK Ltd [2012] EWHC 3415 (Ch)*. The reported decision in that case, however, was limited to the procedural question whether the CCPs should be joined to proceedings. The litigation was settled without resolution of the proprietary claims at issue. A note of the arguments raised in pursuit of the proprietary claims can be found in Lenon, "An

1.9 In that case, the bankruptcy trustee of MF Global Inc. ("**MFG Inc**") sought to pursue a proprietary claim against the administrators of MF Global UK Limited ("**MFG UK**") in respect of collateral consisting of US Treasury Bills which had been transferred by MFG Inc. The claim resulted in proceedings to which UK CCPs were joined.[9] If MFG Inc's claim had succeeded (in the event, the parties reached an out-of-court settlement and the proceedings were terminated), the CCPs would have been deprived of collateral, worth *circa* US$300 million, with which they expected to meet the liabilities to them of MFG UK. Ultimately, a claim of this nature could have prevented the CCPs from resolving MFG UK's positions quickly and efficiently so as to minimise the systemic impact of the default.

1.10 The challenges presented by the *MF Global* claim are by no means inimitable. Analogous difficulties may arise in other, similar situations. For instance, proprietary claims may be brought where:

(a) a client claims that it has beneficial title to collateral in the CM's omnibus (i.e. commingled) client accounts, in circumstances where the share of those assets or monies claimed by the client is greater than the share to which it is entitled according to the books and records of the CCP;

(b) a client claims that it is entitled to larger close-out gains against a defaulting CM and thus to a greater share of a distributable account balance than the corresponding gains or losses determined by the CCP in respect of the terminated clearing member client contract;

(c) an indirect client claims, on a recharacterisation basis, that it has beneficial title to collateral formally provided under a title transfer collateral arrangement and held in a segregated account made available for the purpose by the CCP;

(d) a client or indirect client claims that assets or monies have been erroneously misallocated between client accounts at the CCP level;

(e) a third party makes a claim against assets or monies in a client account on the basis that they are subject to a pre-existing encumbrance.[10]

Each one of these situations is more likely to occur where a defendant CM or client is subject to a bankruptcy event of default. In any situation of heightened systemic risk, however, it is worth noting that the claimant may itself be the administrator or liquidator of the alleged beneficiary. This would exacerbate the complexity of the situation.

Unresolved Collateral Issue: *Re MF Global UK Ltd* and the ownership of US Treasury Bills Posted As Margin" (2014) 7 JIBFL 433.

9 *Ibid*.

10 This list is an illustrative sampling of the situations which may give rise to proprietary claims in respect of positions and assets held in accounts with CCPs and is in no way intended to be exhaustive. A theoretical example of the circumstances which might give rise to competing proprietary claims to collateral is set out in Annex 1 hereto.

1.11 The legislative objective of Part VII is, among other things, to:

> safeguard the operation of certain financial markets provisions with respect to… the insolvency, winding up or default of a person… the effectiveness or enforcement of certain charges given to secure [certain] obligations… and [the] rights and remedies in relation to certain property provided as cover for margin…[11]

Part VII has now been amended, as explained briefly above, to reflect regulatory requirements under EMIR. The amendments include a comprehensive set of revisions designed to enable CCPs, *inter alia*: (i) to offer individual segregated customer accounts which are not combined on the insolvency of a CM; (ii) to port margin to a transferee CM; and (iii) to make leapfrog payments directly to clients on a CM's insolvency.

1.12 Notwithstanding the protections for infrastructure operations and CCPs' default management processes set out in Part VII, the default of a CM or of a client may still disrupt the smooth operation of a CCP if it gives rise to litigation in which clients or indirect clients, or their administrators, seek to vindicate proprietary claims against assets or monies held in accounts provided by the CCP. This situation may arise in the context of the insolvency of a clearing member or a client under the ordinary common law of property and trusts, even where no particular rule or principle of insolvency law is in conflict with the CCP's default management processes.

1.13 The FMLC is concerned that

(a) although Part VII should mitigate the risks of any successful challenge to the porting of positions and collateral and the making of leapfrog payments, there may be residual uncertainty as to the interaction of UK property law with these and other default actions; and

(b) any deficiencies or lack of robustness in the legal protection for CCP or CM default management actions could give rise to a direct conflict between English property law or insolvency procedures and the regulatory intent of EMIR and Part VII which may prove difficult and time consuming for the courts to resolve.

If these concerns are justified, these are issues of legal uncertainty which—albeit the risks are remote—could have significant impact were they to materialise.

<u>Executive Summary</u>

1.14 This paper identifies and, where appropriate, suggests potential solutions to issues of legal uncertainty affecting protections for central clearing established under Part VII Companies Act 1989 and related regulation. The FMLC has drawn attention to issues of uncertainty

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11 Section 154, Part VII of the Companies Act 1989.

arising in the context, in particular, of (i) the protection for CCP's without actual notice of third party interests; (ii) the definition of "margin" in section 177 of the 1989 Act; (iii) the use of client trust acknowledgement letters; (iv) the practical actions which can be taken by a CM to protect itself from becoming unhedged on the default of a client; and (v) the exercise of termination rights by clients.

1.15 To address these uncertainties, the paragraphs below set out a number of proposed solutions including that: (i) further attention should be given to the need for protection against proprietary claims against assets and positions in CCP-provided accounts; (ii) clarification should be given to specific definitions and concepts set out in Part VII; and (iii) consideration should be given to the need to accommodate market best practice, as established by the prevailing industry standard documentation.

1.16 This paper concludes that certain amendments to the legal framework would aid legal certainty and add to the robustness of the legal process for managing defaults: (i) amending section 177 of the Companies Act 1989 in respect of the protection of CCPs without actual notice of third party interests; (ii) giving precedence to the records of the CCP;[12] (iii) clarifying the definition of a CCP's "default rules" to ensure that steps taken by CCPs and CMs in relation to segregated client accounts held with a CCP on a CM client default (where the client is acting as an intermediary offering indirect clearing services) are covered; and (iv) amending the Client Money and Client Assets rules in the FCA Handbook ("**CASS**") to include an express requirement that firms transferring client money to CCPs should only do so to accounts which are made available by the recipient for usage as a client transaction account (and not other accounts).

2. CLEARING MEMBER DEFAULT

2.1 In the UK, CCPs' default rules are protected by law from various possible legal challenges, including those which may arise under insolvency or property law. The legal regime for these protections is established primarily under Part VII of the Companies Act 1989. The CCP itself, and the system as a whole, are protected, *inter alia*, by the provisions of:

(a) section 159: preventing, among other things, an administrator or other office-holder from taking any action which might interfere with the transfer of client contracts "in accordance with the default rules of a recognised [CCP]"; and

12 The FMLC notes that these steps would be consistent with protections afforded to other market infrastructure providers, namely central securities depositories such as CREST, in the Uncertificated Securities Regulations 2001.

(b) section 177: allowing a CCP to apply margin (i.e. collateral) provided by a defaulting CM in accordance with its operating rules, including by netting that collateral against the CM's liabilities to the CCP.[13]

2.2 Clients and indirect clients are protected by the provisions of section 155A on qualifying collateral arrangements and qualifying property transfers, which facilitate porting and leapfrog payments.

2.3 Outcomes for clients on the default of a CM will also be affected by the CM's adherence to CASS.[14] So, too, may outcomes for the CCP and the system as a whole. It is essential, therefore, that these rules are cohesive, consistent and comprehensive.

Part VII of the Companies Act 1989

Constructive notice

2.4 Section 177(2) of Part VII allows a CCP to apply property in accordance with its rules,

> notwithstanding any prior equitable interest or right, or any right or remedy arising from a breach of fiduciary duty, *unless the… [CCP] had notice of the interest, right or breach of duty* at the time the property was provided as margin or as default fund contribution. (Emphasis added.)[15]

2.5 This provision reflects the "*bona fide* acquirer for value" approach, permitting the CCP freely to apply property it has acquired in the course of its contractual dealings with CMs, provided that it has no notice of any prior interest or right. Notice, in this context, may be either

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13 It is worth stressing here that section 177 covers the application of margin in accordance with any of a CCP's operating rules and not merely with those classified as "default rules".

14 The primacy of default management rules are also set out in:

(1) the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "**SFRs**") , which implement the EU Directive 98/26/EC on Settlement Finality in Payment and Securities Settlement (as amended) and provides insolvency protections in relation to default rules relevant to any payment systems or securities transfers taking place through a 'designated system', including CCPs; and

(2) the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) (the "**FCRs**"), which implement the EU Directive 2002/47/EC (as amended) on financial collateral arrangements and provide insolvency protections in relation to financial collateral held by a CCP and enable it to be applied against liabilities of the defaulter through the operation of close-out netting and the enforcement of a security interest.

The SFR and FCR regimes principally require the protection of designated systems and holders of financial collateral, and the effective operation of netting and enforcement of security, against the adverse effect of insolvency proceedings in EU Member States, and not against the possibility of proprietary claims brought by third parties. Protection against such proprietary claims is a (policy) matter of domestic competence and discretion and, as such, can be more appropriately addressed through amendments to UK legislation.

Neither the SFRs nor the FCRs are examined in this paper.

15 To buttress the protection given to a CCP in a default situation, section 183 of Part VII provides that insolvency proceedings in foreign jurisdictions will not be enforced in the UK to the extent that they are inconsistent with the Companies Act 1989. More generally, CCPs are protected from liability as long as actions are taken in good faith.

actual notice or constructive notice (defined, apparently non-exhaustively, in section 190(5) of the 1989 Act).[16]

2.6 Where a client argues that it has beneficial title to assets in a defaulting CM's proprietary accounts, a proprietary claim by that client may disrupt the application of the CCP's established default processes—a point which is highlighted in paragraphs 1.8 to 1.10 above. Circumstances of this nature gave rise to a dispute between two group companies and the intervention of UK CCPs in the *MF Global* litigation.[17] Had the claim of MFG Inc prevailed, the CCPs would have been deprived of collateral worth *circa* US$300 million with which they expected to meet the liabilities to them of MFG UK. Ultimately, a claim of this nature could have systemic implications.

2.7 A similar difficulty could arise, as noted in paragraph 1.10, where a client argues that it has a beneficial entitlement to a share of assets in an omnibus segregated account which exceeds the allocation of those assets documented by the CM and reflected in the relevant books and records. In these circumstances, where assets belonging to an individual client are alleged to be commingled—either properly, in the case of the omnibus account, with those of other clients or improperly, in the case of a proprietary account, with those of the CM—a CCP would likely only be able to respond to notice of the entitlement contended for by first freezing the account and, then, by closing it down entirely, i.e. by liquidating all contracts and assets on the account. Either outcome could prove disruptive and would, respectively: a) in the case of proprietary accounts, prevent a CCP from netting off collateral received from the defaulting CM, thereby minimising the systemic impact of the default on the CCP itself and the other CMs; or b), in the case of omnibus accounts, interfere with the CCP's ability to port other clients' assets.

2.8 The FMLC is concerned that this result may—particularly in the case of proprietary claims against the CCP based on its alleged constructive notice—run contrary to the objectives of EMIR. These objectives include both those reflected in the provisions on porting and the general legislative aims referred to in paragraph 1.3 above. While Article 48 of EMIR makes it clear that contractual terms obliging a CCP to port assets will remain subject to the operating rules of the CCP (which will permit the liquidation of client positions in specified circumstances), national laws that, in effect, require the CCP to freeze or liquidate positions in order to respond to proprietary claims of which it has no actual notice at the time those assets were acquired arguably run contrary to the regulatory intent.

2.9 A client (or alleged client) may assert that constructive notice exists as a result of informal business conversations or a diligence questionnaire, perhaps some time before the collateral was provided. If a claim were made on this basis, the client's statement of claim could allege

16 Section 190(5) provides:

> For the purposes of this Part a person shall be taken to have notice of a matter if he deliberately failed to make enquiries as to that matter in circumstances in which a reasonable and honest person would have done so.

17 *Supra* n.8.

that the CCP had notice in accordance with section 190(5) of Part VII. The litigation could take a very considerable time to resolve. To the extent that the system as a whole and/or the porting of other clients' assets were adversely affected, this would run contrary to the legislative intent of EMIR.

Definition of margin held "in relation to a market contract"

2.10 A second issue to which the drafting of section 177 may give rise concerns the scope of the protections it affords to contracts entered into by a CCP. Section 177(1) provides:

> The following provisions have effect with respect to the application by a… [CCP] of property (other than land) held by the… [CCP] as margin *in relation to a market contract or as default fund contribution*. (Emphasis added.)

Here, "market contract", which is defined at length in section 155 of the 1989 Act, means, principally: a "clearing member house contract" or a "clearing member client contract". That is, a market contract is a transaction recorded in the accounts of CCP as a position held for the account of the CM or its client, as the case may be.

2.11 It is not wholly clear that a provision which covers collateral held in relation to "a market contract" will afford comprehensive protection in relation to all the entitlements held by a CCP at the time of a CM's default. CCPs often hold surplus collateral as a result of a required over-collateralisation under Article 39(6) of EMIR or CMs transferring a "buffer" to manage their own risk. While it is arguable that surplus margin acquired in these ways is indeed held in consequence of a market contract between the CCP and the CM and is, therefore, held "in relation to" such a contract, the point is far from being beyond doubt or contrary argument.

2.12 A similar point can be made with respect to close-out gains made by the CM in relation to proprietary or client positions. These are not "margin" or collateral in the conventional sense, even if they are amounts which the CCP is likely to treat as cover for CM positions in certain circumstances.

2.13 A CCP would expect to net off surplus collateral and close-out gains against the liabilities of the CM, under the CCP's operating rules, in order to protect the system as a whole from the consequences of the default where there has been a collateral shortfall in relation to losing proprietary positions. And a CCP is required to port close-out gains and surplus collateral in relation to client positions under EMIR.

2.14 The FMLC is concerned that, without full legislative protection for these entitlements, the regulatory intent of EMIR and the objectives of Part VII may be partly undermined in the event of a default. Were a client or the CM's administrators to bring a proprietary claim in respect of assets or monies held in a defaulting CM's proprietary or house accounts which do not fall within the scope of section 177, this could possibly have the unfortunate consequences described in paragraphs 2.6 to 2.9 above.

CASS 7 – client money and client transaction accounts

2.15 The FMLC is also concerned that a CCP's ability to net and apply collateral to minimise systemic disruption on the default of a CM could potentially be affected by a CM's mistaken, careless or improper issuance of an "acknowledgement letter".[18] Such a letter may be issued in respect of an account in order to designate it as a client transaction account and thereby place the CCP on notice that all monies in the account are held on trust by the CM and not to be netted-off against its liabilities.

2.16 Mistaken, careless or improper issuance of such an acknowledgement letter in respect of an account would have this effect, even were the account in question, in fact, being operated as a proprietary account beneficially owned by the CM or as an account designated for the receipt of title transfer collateral from clients (in respect of which no beneficial title is retained by the client). Yet, the CASS rules do not expressly require firms to ensure that client money held by a CM and intended to be posted as margin with a CCP is duly transferred to a designated client account. A CM may thus, having operated a proprietary account for its own benefit, transfer client monies into that account—or acquire them in that account in connection with transactions that the CM has entered into on behalf of the client—having first designated the entire account as a client account by serving an acknowledgement letter. This could occur as the result of an error or an intentional shortcut but it carries the risk of undermining the CCP's ability to resolve the CM's positions effectively on its default. It is, moreover, a practice which would run counter to the framework for client protection set out in Article 39 of EMIR.

2.17 The FMLC is of the view that operational and legal certainty would be fostered by aligning the CASS rules with EMIR and requiring firms to transfer client monies exclusively to accounts which have been made available for usage as client transaction accounts by the relevant CCP.

3. CLIENT DEFAULT

3.1 Further issues with the potential to affect default management in a cleared environment arise concerning the robustness of protection available to CMs for actions taken on the default of their clients.

3.2 Under the EMIR Level 2 Regulation, a CM is required to take steps to protect the interests of any indirect clients who may be affected by the default of a client. These may include, under Article 4(4) and 4(5), porting positions to another client or CM or liquidating the

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18 According to CASS 7.18.4R

> A firm which places client money at an authorised central counterparty in connection with a regulated clearing arrangement must, in accordance with CASS 7.18.6.R, complete and sign an authorised central counterparty acknowledgement letter clearly identifying the relevant client transaction account.

indirect client's positions and making leapfrog payments. Section 155A of the Companies Act 1989, referred to above in connection CCP actions on the default of a CM, also facilitates and protects property transfers and payments of this kind by a CM attempting to deal with the default of a client.

3.3 Where there are no indirect clients, or actions have already been taken to protect their positions and assets, a CM may choose to transfer the defaulting client's positions to its proprietary account. This process is described in the following paragraphs.

Direct clients

3.4 In practice, the CM may wish, in the event of a client default, to transfer transactions from a client account at a CCP to its proprietary account. In particular, a CM may wish to transfer transactions in this way to prevent them becoming unhedged where it has moved to terminate the client trade but the relevant clearing member client contract has not, or has not yet, terminated. The positions will be transferred with collateral cover, which may include assets provided to the CM by the client under a title transfer collateral arrangement. Once moved to the proprietary account, transactions will be offset with existing or new CM transactions. This process protects the CM and the CCP from unnecessary loss and disruption as a result of the client default and, ultimately, can help protect the CM's other, non-defaulting, clients from contagion risk.

3.5 In the absence of protection, a transfer of assets and positions held for the account of a defaulting client could theoretically be open to a proprietary challenge by the defaulting client's administrators in respect of, say, title transfer collateral received from the client and posted to the CCP. A challenge would not have to offer a reasonable prospect of success to be disruptive. In *Re MF Global UK Ltd [2012] EWHC 3415 (Ch)*, the administrators sought to argue that a title transfer collateral arrangement should be recharacterised as a security collateral arrangement and, thus, that collateral which had been transferred to MFG UK remained beneficially owned by MFG Inc.[19]

3.6 The option to make a transfer into the CM's proprietary account on the default of a client is reflected in the operating rules of most CCPs. It is also reflected in standard industry documentation, under which the client will commonly agree that, on its default and the consequent termination of its position by the CM:

> [the CM] may take any action that is required under the relevant [CCP Rules] for the purpose of Transferring the related CM/CCP Transactions from the relevant Client Account to [the CM's] proprietary account[20]

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19 *Supra* n.8. It should be noted that the EMIR rules which provide for client account segregation do so even in respect of assets that the account holder may have passed on a title transfer collateral basis to the CM.

20 See the ISDA/FIA Client Cleared OTC Derivatives Addendum (at clause 8(a)(vi)).

(where "CM/CCP Transactions" refers to clearing member client contracts). This contractual provision should give a court every reason to uphold the transfer of clearing member client contracts and any associated collateral received by the CM on a title transfer basis and posted to the client account,[21] but it does not necessarily preclude a proprietary claim of the sort referred to above—however remote may be its chances of ultimate success. Such a claim might be addressed either to the CM, or to a CCP that acts on the CM's instructions in transferring collateral from the account of a defaulting client to the CM's proprietary account.

3.7 Transfers into the CM's proprietary account of assets and positions may not qualify for the protection against interference by office holders afforded to various transfers by sub-sections 159(2)(c)-(f) of the 1989 Act because such transfers must be made in accordance with the "default rules" of the CCP. The definition of "default rules" in section 188(1) is principally aimed at those rules which provide for the CCP to take action to deal with a defaulting CM or other counterparty, including another CCP or investment exchange. An interpretation which impliedly brings within scope those rules that provide for the taking of action by a CM—or by a CCP at the request of a CM—on the default of a direct client is by no means incontestable. Moreover, later amendments in section 188(1A)(b), which do cover rules providing for the taking of action in accordance with a request or instruction from a CM in respect of a client, are expressly limited to rules which facilitate the porting of indirect clients' assets or positions as mandated by Article 4(4) of the EMIR Level 2 Regulation.

3.8 Although the optional transfer of a defaulting client's transactions to a CM's proprietary account may not fall within the narrow penumbra of a CCP's "default rules", where it is provided for at all, it will certainly fall within the wider category of CCP "operating rules". An application of margin by a CCP pursuant to its "operating rules" is protected by section 177 of the 1989 Act, as mentioned above. Nevertheless, logic suggests that a transfer of this kind will not, or will not indisputably, amount to an "application" of margin by the CCP, for reason that the transfer is made on the instruction or request of the CM.

3.9 Finally, while the CM/CCP margin arrangements are a "qualifying collateral arrangement" within the meaning of section 155A of the 1989, the fact that transfers of such arrangements—and of clearing member client contracts—take precedence over *insolvency* law under sub-section 159(1) is of no assistance in the face of a proprietary claim.

3.10 To accommodate this situation, therefore, the definition of "default rules" in sub-sections 188(1) and 188(1A) could be amended to cover rules which permit the transfer of positions and assets by a CCP from the account of a defaulting client to a CM's proprietary account, pursuant to a request or instruction from a CM under the relevant client trades. This would indirectly bring such transfers within the protections against interference by office holders afforded to actions taken by a CCP in accordance with its default rules under sub-section 159(2) of the 1989 Act.

[21] *Supra* n.18: EMIR rules which provide for client account segregation do so even in respect of assets that the account holder may have passed on a title transfer collateral basis to the CM.

Indirect clients

3.11 In the case of indirect clients, amendments to the definition of "default rules" in section 188 have already been made to protect actions taken by CCPs in accordance with a request by a CM to port the relevant assets and positions from a defaulting client to a non-defaulting client, as envisaged by Article 4(4) of the EMIR Level 2 Regulation. These amendments, which were introduced in 2013 by SI 2013/1908,[22] do not, however, contemplate steps taken by a CM, or a CCP at the request of a CM, in respect of payments to indirect clients following a liquidation of the client's positions under Article 4(5) of the EMIR Level 2 Regulation:

> […]
>
> (5) The clearing member shall also ensure that its procedures allow for the prompt liquidation of the assets and positions of indirect clients and the clearing member to pay all monies due to the indirect clients following the default of the client.

3.12 A transfer of close-out gains by a CM to indirect clients in this situation will fall within the definition of "qualifying property transfers" in section 155A of the 1989 Act and in particular with sub-section 155A(4)(aa), one of the new provisions introduced by SI 2013/1908.[23] It will, on this basis, qualify for the protection against interference by office holders afforded to qualifying property transfers by sub-section 159(2)(g) of the 1989 Act.[24]

3.13 In the circumstances described in paragraph 3.4 above, however, the CM may need to terminate the client trade while being unable to terminate the corresponding clearing member client contract under the rules of the CCP. In these circumstances, the CM may wish to transfer the clearing member client contract to its proprietary account so that the transaction can be offset with others. This will be almost certainly be contemplated the contract documenting the client trade.[25] Gains and loses realised by the CM as a result of the transfer and the offset will be taken into account in order to determine the applicable close-out amount under the client trade and this, ultimately, will affect the monies due to the indirect clients, even where the position of the indirect clients has been liquidated.[26] For that

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22 The Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) (No 2) Regulations 2013—regulations by means of which the EMIR Level 2 Regulation was implemented in the U.K. Corresponding amendments were also made by SI 2013/1908 to the definitions of "qualifying collateral arrangements" and "qualifying property transfers" under section 155A, see paragraph 3.14 *infra*. As to section 155A, see n.23 *infra*.

23 Section 155A itself was introduced by the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013, SI 2013/504—the regulations by means of which EMIR was first implemented in the U.K.

24 Unlike the transfers contemplated by sub-sections 159(2)(c)-(f), actions taken to give effect to a qualifying property transfer do not need to be taken "in accordance with the default rules of [a CCP]" to qualify for protection.

25 See the ISDA/FIA Client Cleared OTC Derivatives Addendum (at clause 8(a)(iv)(2)(B)).

26 The chief objective of the close-out methodology set out in market standard documentation for cleared OTC derivatives transactions is to permit the CM to determine its losses from the action it takes to offset client clearing contracts which are no longer hedged. Thus, in determining the early termination amount the client or CM is obliged to treat the values of the

reason, it is arguable that the transfer of the clearing member client contract should be a protected transfer—that is, because it facilitates procedures mandated by Article 4(5) of the EMIR Level 2 Regulation.

3.14 Such a transfer, however, will not amount to a qualifying property transfer within the meaning of sub-sections 155A(1) and (4) of the 1989 Act. While sub-section 155A(4)(c) contemplates transfers made to a clearing member on the default of a client, the transfer must be to "another" clearing member and the transfer must represent the termination value of the client trade, rather than the extant (i.e., open) position under the corresponding clearing member client contract.[27] Nor will the transfer qualify for the protection against interference by office holders afforded to various transfers by sub-sections 159(2)(c) to (f) of the 1989 Act because such transfers must be made in accordance with the "default rules" of the CCP. The definition of "default rules" in section 188(1) was amended by SI 2013/1908, as mentioned in paragraph 3.11 above, to include rules which facilitate the porting of indirect clients' assets or positions as mandated by Article 4(4) of the EMIR Level 2 Regulation but not so as to include rules which facilitate a termination and the resulting liquidation of the assets and positions of indirect clients under Article 4(5). It may be that an amendment of this kind was thought unnecessary in light of the new provisions discussed in paragraph 3.12 above but, in the view of the FMLC, consideration could usefully be given to protecting transfers of positions and assets into the CM's proprietary account where these are made in accordance with the rules of the CCP and for the purpose of complying with Article 4(5) of the EMIR Level 2 Regulation. To achieve this, the definition of "default rules" in sub-section 188(1A)(b) could be amended so as to refer to rules which provide for the taking of action at the request of a CM under procedures referred to in Article 4(4) *or* in Article 4(5) of the EMIR Level 2 Regulation.

4. AUTOMATIC, UNILATERAL AND CONSENSUAL TERMINATION

4.1 In the circumstances of client default described in paragraph 3.4 above, a CM may wish to transfer a clearing member client contract, where the corresponding client trade has terminated on default by the client and in circumstances where the clearing member client contract cannot be terminated under the rules of the CCP. This, however, is not the only situation in which a client trade may be terminated and the corresponding clearing member client contract transferred. Clients themselves may terminate a trade for a variety of reasons, including (without limitation) as a response to European regulatory measures. Highly-regulated "UCITS" funds must be able to sell, liquidate or offset the instruments in which

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terminated client trades as being equal to the values of the terminated clearing member client contracts, even where termination between the CM and the CCP occurs later. Where there is no termination between the CM and the CCP, because a transfer to the CM's proprietary account has occurred, the CM may determine its losses by taking into account the cost of offsetting the clearing member client contract with new transactions.

[27] Under the other elements of the definition in sub-sections 155A(1) and (4), which deal with a variety of default situations, a transfer must be made to a client, an indirect client or to a "non-defaulting clearing member instead of, or in place of, a defaulting clearing member" to constitute a qualifying property transfer.

they invest "at any time";[28] regulatory capital requirements will mean that client financial institutions insist on rigorous termination and close-out netting clauses;[29] and an election for "Automatic Early Termination" may be strongly indicated by the legal system which constitutes the governing law of the contract.[30] Even where a client trade is terminated pursuant to both its terms and the relevant regulation or governing law, the rules of the CCP may prevent termination of the corresponding clearing member client contract in order to preserve the integrity of the system and to prevent the CCP itself becoming unhedged. In circumstances where the client terminates on the default of a CM, in particular, CCP rules may make this provision, in part, to assist with the porting and the protection of the CM's other clients.

4.2 The section above argued that the definition of "default rules" in Part VII does not adequately provide for a situation in which a client trade is terminated by a CM which then wishes to transfer the corresponding clearing member client contract to its proprietary account. A similar problem arises in relation to the definition of "transfer" in section 189A, which includes provision as follows:

> (1) […]
>
> (2) A transfer of a clearing member client contract or client trade includes—
>
> (a) an assignment;
>
> (b) a novation; and
>
> (c) terminating or closing out the clearing member client contract or client trade and establishing an equivalent position between different parties.
>
> (3) […]
>
> (4) […]

It is used in several provisions by means of which Part VII confers insolvency law protections on CCPs and CMs, including in the definition of "qualifying property transfer" in

28 See Article 50(1)(g)(iii) of Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

29 The Capital Requirements Regulation (Regulation 575/2013) requires a party to a derivative to have a right of close-out netting in order for collateral to be recognised as risk mitigation against exposures under the contract. Pursuant to Article 206(b), such close-out netting provisions must

> give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty.

30 Parties may elect under Part 1(e) of the Schedule to an ISDA Master Agreement for "Automatic Early Termination" ("AET") to apply to when certain insolvency events occur. Under the insolvency laws of certain jurisdictions—e.g. Germany (except for credit institutions), Japan, the Netherlands and Switzerland—statutory provision has been made which can override close-out netting terms. In these circumstances it is conventional and useful for the parties to elect for AET.

sub-sections 155A(1) and (4) and in the provisions regarding non-interference by office holders in sub-sections 159(2)(c) to (f).

4.3 The definition does not easily accommodate the idea that a client trade and a clearing member client contract may be terminated at different times and that either one may be transferred after the other has terminated on its own terms. This is partly because section 189A(2)(c), which is intended to facilitate porting, implies that "terminating" one contract and "establishing" another will be contemporaneous events and partly because the position which the CCP is "establishing" and the position which it is "terminating" must be "equivalent" (which arguably means, at the very least, for the continuing economic benefit of the same client or indirect client). It also has to do with the definitions of "clearing member client contract" and "clearing member house contract" in Part VII.

4.4 In the situation where the client trade is terminated by a clearing member on the default of the client, a transfer of the clearing member client contract into the proprietary account of the CM would almost certainly entail that the contract ceased to qualify as a clearing member client contract, within the statutory meaning of the term. It is possible that the transfer could be characterised as an "assignment" of the client's interest, where such assignment is contractually agreed under the terms of the client trade, but it would not amount to an assignment of the corresponding clearing member client contract between the CM and the CCP. Equally, while one might say that the clearing member client contract has terminated along with the client trade and the position has been re-opened as a clearing member house contract, it is to be doubted that the new position would be an "equivalent" one "between different parties" under sub-section 189A(2)(c). It might well not be "equivalent", being a house contract, rather than a client contract, and benefitting from a new hedge but it would still be a contract between the original parties—i.e., the CM and the CCP.

4.5 Where a transposition of a contract in this way fails to qualify as a "transfer" for the purposes of Part VII, it may, as suggested above, conceivably be vulnerable to proprietary claims by administrators in respect of close-out gains and assets used as collateral. A claim of this sort would be disruptive even were its chances of success to be very remote.

4.6 A consensual termination between a CM and a client will typically be managed in the client trade documentation in the same way as a client default and may lead to similar issues if the CCP rules will not permit the simultaneous termination of the clearing member client contract.

4.7 Analysing the very different situation in which a clearing member client contract is automatically terminated by a CCP on the occurrence of a bankruptcy event of default by the CM, gives rise to a similar problem but with different results. Here, the client trade documentation will almost certainly provide for automatic termination of the client trade as a consequence of the same default.[31] The CCP will, however, have contractually committed

[31] See the ISDA/FIA Client Cleared OTC Derivatives Addendum (at clause 8(b)(ii)(1)).

itself, as required by Article 48 of EMIR, to trigger procedures for the transfer of the assets and positions held by the defaulting clearing member for the account of its clients to another clearing member. That action must be carried out within a predefined transfer period following the default. To facilitate this possibility, the rules of the CCP may purport to suspend or render void the client's termination against the CM. Thus, circumstances may arise in which the CCP considers that it is obliged to port a client trade where the clearing member client contract has already automatically terminated.[32]

4.8 On the establishment of a new position in these circumstances, the records of the CCP will reflect the new clearing member client contract as a position held for the account of a client but, in view of the fact that the clearing member client contract was terminated automatically before the new contract was established, it may not be clear that the transaction has been "transferred" within the meaning of sub-section 189A(2)(c). That is, because the act of "terminating" and the act of "establishing" do not necessarily occur contemporaneously. Alternatively, from the client's perspective, where the client trade has automatically terminated on its own terms but that termination has been voided by the rules of the CCP, there may be uncertainty as to whether the new clearing member client contract can accurately be described as a position "equivalent" to the pre-existing contract within the meaning of sub-section 189A(2)(c).

4.9 Accordingly, it is to be doubted whether the protection against interference by office holders afforded to various "transfers" by sub-sections 159(2)(c) to (f) of the 1989 Act will be available in the situation where a client trade and the corresponding clearing member client contract are closed out at different times. In the absence of such protection it is possible that the transfers will be challenged by a proprietary claim on close-out gains or collateral associated with the clearing member client contract. In the view of the FMLC, therefore, consideration should be given to extending the definition of "transfer" to include situations in which a contract is transferred or re-established by a CCP notwithstanding the contract itself or the corresponding client trade may already have terminated.

4.10 SI 2013/1908 introduced Section 189A (like several other statutory provisions discussed in this paper), to implement the EMIR Level 2 Regulation and to facilitate "the transfer of indirect client accounts on the failure of a client providing indirect clearing services".[33] "Transfer", however, is not defined in either EMIR or the EMIR Level 2 Regulation—although it is frequently used in both. A purposive interpretation would accommodate both transfers which port client positions and assets and those which help mitigate risks to the system, while avoiding conflict with any regulatory requirements or CCP rules which provide for the automatic or unilateral termination of transactions.

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32 A similar CCP rule may purport to suspend or render void a unilateral termination by a client against a CM in less exigent circumstances. In general, market standard documentation for cleared trades does not allow the client recourse to termination for defaults other than CM bankruptcy but, as mentioned above, some UCITS may insist on a bespoke right of unilateral termination under the regulation which applies to their business. CCP rules may purport to abrogate this right. This practice was noted by ESMA in an opinion published 22 May 2015 (see paragraphs 30 to 31), available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-880_esma_opinion_on_impact_of_emir_on_ucits.pdf

33 See the Explanatory Note to SI 2013/1908.

4.11 The chief objective of the close-out methodology set out in market standard documentation for cleared OTC derivatives transactions is to permit the CM to recover its losses from any action it may take to offset clearing member client contracts which are no longer hedged. Thus, in determining the early termination amount the client or CM is obliged to treat the values of the terminated client trades as being equal to the values of the terminated clearing member client contracts, even where termination between the CM and the CCP occurs later. This ensures that a CCP default valuation, in the event of a CM bankruptcy, will apply to a client trade which has terminated for the same default. Care should be taken that a wider definition of "transfer" does not allow a client to terminate a client trade unilaterally and then to obtain either a transfer of the clearing member client contract on the basis of a subsequent bankruptcy default, or a favourable valuation on the basis that such a transfer is deemed to have occurred.

5. POTENTIAL SOLUTIONS

5.1 The sections above make the case for carefully scrutinising the drafting of Part VII of the Companies Act 1989 and CASS rules in light of the need to ensure a thorough-going protection for a robust clearing system and effective implementation of regulatory requirements under EMIR. If the view is taken that additional amendments could usefully address the legal uncertainties outlined above, the FMLC recommends further consideration of the following:

(a) The requirements with respect to notice in sections 177 and 190 of the Companies Act 1989 could be amended such that a CCP shall have regard only to actual notice of a particular kind, made in a particular way and at a particular moment in time.

(b) To give more legal certainty in relation to porting under EMIR, the broader exculpatory provisions protecting CCPs from insolvency claims in section 182A of the Companies Act 1989 could be expanded to prevent proprietary claims against CCPs or CMs undertaking porting or leapfrog payments and their transferees. CASS 7.18.4 letters (and similar written notices of encumbrances issued by clearing members based in other jurisdictions) would remain effective under this approach but third party claims with potentially systemic impacts contrary to the policy of EMIR would be reduced.

(c) Bankers' books could be given evidential status under the Bankers' Books Evidence Act 1879. Such a standard could appropriately be adopted for the books and records of CCPs, in order to protect CCPs, transferee clearing members and clients who receive assets pursuant to EMIR. CCPs could proceed with porting on the basis of their accounts, records, formal notices and rules, and recipients of collateral would have comfort in receiving assets from CCPs, with reduced risks of proprietary claims being made later by third parties.[34]

(d) Section 177 could be amended so as to extend the protections of CCPs against any legal interests or rights, so as to capture the full range of any proprietary claims, including any common law claims.

(e) Section 177 could be extended in scope to cover assets (in addition to margin) that a CCP may be expected to port or transfer to third parties, such as surplus collateral and gains realised on a close-out.

(f) The amendments to section 177 discussed above could also protect porting and leapfrog payments by CMs in an indirect clearing arrangement.

(g) The definition of "default rules" in section 188 could expressly cover actions taken by a CCP to support liquidation, position transfers and leapfrog payments by CMs on a client default.

(h) The definition of "transfer" in section 189A could be expanded to include situations where one of the contracts has already been terminated in connection with or as a result of the same situation resulting in applicability of the default rules. Moreover, the definitions of market contracts in section 155 could be amended to offer broader protections in situations where a contract has already been terminated.

(i) CASS 7.14 could be amended in order to impose explicit obligations on CMs to transfer client money only into accounts that are designated by CCPs for usage as client transaction accounts.

5.2 Examples of these amendments are set out in Annex 2 and Annex 3 to this paper.[35] Such changes would reduce legal uncertainty in this area by strengthening the legislative protection afforded to the clearing system and by removing potential inconsistencies between UK legislation and the regulatory intent of EMIR.

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34 This would operate in a manner analogous to Regulation 35(5)(d) of the Uncertificated Securities Regulations 2001 ("USRs"), which provides that the operator of CREST may rely on properly authenticated dematerialised instructions as authoritative statements except where it receives actual notice of a specified event. Regulation 24 of the USRs further provides that "a register of members [operated by an operator such as CREST] is prima facie evidence, and in Scotland sufficient evidence unless the contrary is shown, of any matters which are by these Regulations directed or authorised to be inserted in it". (Similar provisions in relation to bank accounts are found in section 3 of the Bankers' Books Evidence Act 1879. The non-application of such provisions to CCPs is a current legal lacuna.) Moreover, Regulation 44 of the USRs provides that: "For the purpose of determining under these Regulations whether a person has actual notice of a fact, matter or thing that person shall not under any circumstances be taken to be concerned to establish whether or not it exists or has occurred."

35 The FMLC is grateful to Barney Reynolds, Shearman & Sterling LLP, for suggesting the drafts in these Annexes.

6. CONCLUSION

6.1 The objective of this paper has been to identify and, where appropriate, suggest potential solutions to issues of legal uncertainty affecting the system of protections for central clearing established under Part VII Companies Act 1989 and related regulation. The FMLC has drawn attention to issues of uncertainty arising in the context, in particular, of (i) the protection for CCP's without actual notice of third party interests; (ii) the definition of "margin" in section 177; (iii) the use of client trust acknowledgement letters; and (iv) the practical steps typically taken by a CM to protect itself from becoming unhedged on the default of a client; and (v) the exercise of termination rights by clients.

6.2 To address these uncertainties, the FMLC has made recommendations which include that further (i) attention is given to the need for protection against proprietary claims against assets and positions in CCP-provided accounts; (ii) clarification is given to specific definitions and concepts set out in Part VII; and (iii) consideration is given to the need to accommodate market best practice, as established by the prevailing industry standard documentation. These recommendations have been amplified, where appropriate, by suggestions for revisions to Part VII of the 1989 Act and related regulation which could be adopted if amendments were thought desirable.

ANNEX 1: HOW PROPRIETARY CLAIMS TO COLLATERAL MAY ARISE

—AN EXAMPLE—

Proprietary claims to collateral may arise as follows:

1. A CM posts margin to the CCP in respect of a segregated client account. Such margin may comprise either collateral funded by the CM itself,[36] or collateral provided to the CM by its clients and onwardly transferred by the CM. Then, either:

   (a) assets (which may already be encumbered with third-party interests) which are not referable to the relevant client are erroneously introduced into an individually or omnibus segregated client account, (or client assets are erroneously introduced into one of a CM's own proprietary accounts); or

   (b) funds are erroneously (or as a result of fraud or breach of trust) misallocated between client accounts.

   The CM subsequently becomes insolvent and the CCP (in accordance with its default management rules), with the consent of the client to which the account is identified in its records as being referable, ports the insolvent CM's segregated client positions and margin to another CM (the "**Transferee CM**") pursuant to EMIR.

2. The following developments could occur:

   (c) the third party whose assets were erroneously introduced to the client account held with the CCP takes action against the CCP, Transferee CM or client to recover its funds;

   (d) the third party whose assets were erroneously introduced to the client account held with the CCP takes action against the CCP for wrongful porting of its assets from the defaulting CM to the Transferee CM, wrongful application of those assets against losses on the same account or wrongful making of a leapfrog payment;

   (e) the third party whose assets were erroneously placed in a proprietary account takes action against the CCP for wrongful application of those assets against losses on the same account; or

36 For operational reasons, many clients cannot respond to margin calls on a sufficiently timely basis daily, and therefore CMs may pre-fund their client margin positions as part of the service they offer to clients. Such "pre-funding" is, in accordance with ESMA's EMIR Q&As (CCP Question 8(f)), usually analysed as a loan from the CM to its client and the margin posted is therefore client money. Difficulties could arise in the event that the CM notifies the CCP that such pre-funding was not by way of loan, but actually constituted the introduction of house assets to the client account and that the CM maintained its proprietary rights to such assets. Other CMs offer collateral transformation, receiving assets ineligible as collateral for CCPs from their clients and transferring different eligible assets of similar value to the CCP.

(f) the CM takes action against the CCP or Transferee CM in relation to assets in the client account that it had funded itself or loaned to the client or in respect of which it had taken title, which were subsequently ported to a Transferee CM.

3. A claimant's claim against a CCP, Transferee CM or client recipient would likely be for a proprietary remedy, where available. The relief sought could include tracing of assets representing the ported margin and a claim that such assets be returned, in the case of third party assets, or reallocated, in the case of misallocation amongst omnibus-segregated clients, by the Transferee CM or client. The equitable defence of "*bona fide* purchaser for value without notice" would typically be asserted by the CCP, relying on section 177 of the 1989 Act, or the Transferee CM, who would have taken on the collateral as security for liabilities under cleared contracts, either under a title transfer or security collateral arrangement. A claimant would then assert that the Transferee CM, client or CCP was on notice of its interest.

4. Third party claimants might also seek to assert a proprietary claim against the CCP directly, on the basis of breach of trust, money had and received, knowing receipt or conversion. If successful, such an action would result in a judgment against the CCP or CM the measure of which would not be covered by any margin of the defaulter. The judgment would probably have to be met, in the case of the CCP, from the default fund of the CCP and levied on non-defaulting CMs and the CCP itself.

5. Very similar situations could occur in the context of an indirect clearing relationship and result in claims against the CCP, the CM and/or the client.

ANNEX 2: PROPOSED AMENDMENTS TO THE COMPANIES ACT 1989[37]

155 Market contracts

(1) (1) In this Part—

(a) "clearing member client contract" means a contract between a recognised central counterparty and one or more of the parties mentioned in subsection (1A) which is recorded in the accounts of the recognised central counterparty as a position held for the account of a client, an indirect client or a group of clients or indirect clients (or a contract that was so held immediately prior to it being terminated or rescinded as a result of or in connection with a default, whether by operation of law, automatic termination under provisions of the contract or otherwise);

(b) "clearing member house contract" means a contract between a recognised central counterparty and a clearing member recorded in the accounts of the recognised central counterparty as a position held for the account of a clearing member (or a contract that was so held immediately prior to it being terminated or rescinded as a result of or in connection with a default, whether by operation of law, automatic termination under provisions of the contract or otherwise);

(c) "client trade" means a contract between two or more of the parties mentioned in subsection (1A) which corresponds to a clearing member client contract (or which corresponded to a clearing member client contract immediately prior to it being terminated or rescinded as a result of or in connection with a default, whether by operation of law, automatic termination under provisions of the contract or otherwise);

(d) "market contracts" means the contracts to which this Part applies by virtue of subsections (2) to (3) (or such contracts prior to being terminated or rescinded as a result of or in connection with a default, whether by operation of law, automatic termination under provisions of the contract or otherwise).

[…]

177 Application of margin or default fund contribution not affected by certain other interests

(1) The following provisions have effect with respect to the application by a recognised investment exchange or recognised clearing house of property (other than land) held by the exchange or clearing house as margin or otherwise available to it as collateral or as cover for collateral in relation to a market contract or as default fund contribution or as a result of the proceeds of termination, transfer or liquidation of market contracts. Such an application of property shall include any application of property pursuant to the default rules, default procedures, a qualifying collateral arrangement or qualifying property transfer.

(2) So far as necessary to enable the property to be applied, dealt with or transferred in accordance with the rules of the exchange or clearing house or a qualifying collateral arrangement or qualifying property transfer, it may be so applied, dealt with or transferred

[37] The FMLC is grateful to Barney Reynolds, Shearman & Sterling LLP, for suggesting these drafts.

(and may be received by any person) notwithstanding any prior legal or equitable interest or right, or any right or remedy arising from a breach of fiduciary duty, unless the exchange or clearing house had actual notice from a member of the exchange or clearing house respectively with respect to the property in question concerning ~~of~~ the interest, right or breach of duty at the time the property was provided as margin or as default fund contribution.

(3) No right or remedy arising subsequently to the property being provided as margin or as default fund contribution may be enforced so as to prevent or interfere with the application, dealing with or transfer of the property by the exchange or clearing house or to a member or a client in accordance with ~~its~~ the exchange's or clearing house's default rules.

(4) Where an exchange or clearing house has power by virtue of the above provisions to apply, deal with or transfer any property notwithstanding an interest, right or remedy, a person to whom the exchange or clearing house transfers ~~disposes of~~ the property in accordance with its rules also takes free from ~~that~~ any such interest, right or remedy.

(5) Subject to actual notice under section 177(2), the records of the exchange or clearing house are prima facie evidence, and in Scotland sufficient evidence unless the contrary is shown, of market contracts, margin and default fund contributions and the accounts in which they are recorded.

(6) Subject to actual notice under section 177(2), nothing in common law or equity shall prevent a recognised investment exchange or recognised clearing house from taking action under its default rules or default procedures or giving effect to a qualifying collateral arrangement or qualifying property transfer nor shall give rise to any claim by any third party in common law or equity against such a recognised investment exchange or recognised clearing house for doing so.

177A Application of margin by a clearing member not affected by certain other interests in relation to indirect clearing

(1) The following provisions have effect with respect to the application by a clearing member pursuant to a qualifying collateral arrangement or qualifying property transfer of property (other than land) held by it as margin or otherwise available to it as collateral or as cover for collateral in relation to a market contract or as a result of the proceeds of termination, transfer or liquidation of market contracts.

(2) So far as necessary to enable the property to be applied, dealt with or transferred in accordance with a qualifying collateral arrangement or qualifying property transfer, it may be so applied, dealt with or transferred (and may be received by any person in accordance with Articles 4(4) or 4(5) of the EMIR Level 2 Regulation) notwithstanding any prior legal or equitable interest or right, or any right or remedy arising from a breach of fiduciary duty, unless the clearing member had actual notice from its client with respect to the property concerning the interest, right or breach of duty in question at the time the property was provided as margin.

(3) No right or remedy arising subsequently to the property being provided as margin to the clearing member may be enforced so as to prevent or interfere with the application, dealing with or transfer of the property by the clearing member or to a client or indirect client in accordance with a qualifying collateral arrangement or qualifying property transfer.

(4) Where a clearing member has power by virtue of the above provisions to apply, deal with or transfer any property notwithstanding an interest, right or remedy, a person to whom the clearing member transfers the property in accordance with a qualifying collateral arrangement or qualifying property transfer also takes free from any such interest, right or remedy.

(5) Subject to sections 177(2) and (5) and to actual notice under section 177A(2), the records of the clearing member are prima facie evidence, and in Scotland sufficient evidence unless the contrary is shown, of market contracts, margin and default fund contributions and the accounts in which they are recorded.

(6) Subject to section 177A(2), nothing in common law or equity shall prevent a clearing member from giving effect to a qualifying collateral arrangement or qualifying property transfer or shall give rise to any claim by any third party in common law or equity against such a clearing member for doing so.

188 Meaning of "default rules" and related expressions

[…]

(1A) In the case of a recognised central counterparty, "default rules" includes—

(a) […]

(b) any rules of the recognised central counterparty which provide for the taking of action in accordance with a request or instruction from a clearing member under the default procedures referred to in Articles 4(4) or 4(5) of the EMIR Level 2 Regulation in respect of assets or positions held by the recognised central counterparty for the account of an indirect client or group of indirect clients.

(c) any rules of the recognised central counterparty which provide for the taking of action in accordance with a request or instruction from a clearing member pursuant to one or more client trades in respect of assets or positions held by the recognised central counterparty for the account of a defaulting client [and not for the account of an indirect client or group of indirect clients].

189A Meaning of "transfer"

[…]

(2) A transfer of a clearing member client contract or client trade includes—

(a) an assignment;

(b) a novation; ~~and~~

(c) terminating or closing out the clearing member client contract or client trade and establishing an equivalent position between different parties; and

(d) the clearing member client contract or client trade already having been terminated or rescinded as a result of or in connection with the default (whether by operation of law, automatic termination under provisions of the contract or otherwise), establishing an equivalent position between different parties .

[...]

190 Minor definitions

[…]

(5) For the purposes of determining under this Part whether a person ~~shall be taken to have~~ has actual notice of a fact, matter ~~if he deliberately failed to make enquiries as to that matter in circumstances in which a reasonable and honest person would have done so.~~or thing that person shall not under any circumstances be taken to be concerned to establish whether or not it exists or has occurred.

A person shall be taken to have actual notice of a fact, matter or thing if that person has received written notice describing such fact, matter or thing.

ANNEX 3: PROPOSED AMENDMENTS TO CASS[38]

Insertion of new paragraph to CASS 7.14

7.14.3 G

Client money that a *firm* allows another person to hold under CASS 7.14.2 R:

(1) should only be held for transactions which are likely to occur (and for which the other *person* needs to receive *client money*) or have recently settled (and such that the other *person* has received *client money*); ~~and~~

(2) should be recorded in *client transaction accounts* by that other *person*; and~~.~~

(3) must only be transferred by the *firm* to an account which has been or is intended to be designated by that *person* as a *client transaction account* maintained by that *person* (and not to an account designated for other purposes, such as a proprietary account or a customer account intended for usage by customers using title transfer financial collateral arrangements under the *Financial Collateral Directive*).

[38] The FMLC is grateful to Barney Reynolds, Shearman & Sterling LLP, for suggesting this draft.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS[39]

[39] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.