Feature

KEY POINTS

- The definition of "transfer" in s 189A Companies Act 1989 should include the situation in which a clearing member client contract between a central clearing counterparty (CCP) and one clearing member is terminated and re-established with another clearing member, even where this occurs after the client trade has terminated on its own terms.
- On a client default, it is doubtful whether the optional transfer of a clearing member client contract by a clearing member to its proprietary account with a CCP will amount to an action in accordance with the CCP's "default rules".
- Where reference is made in s 177 Companies Act 1989 to "property … held … as margin in relation to a market contract", this should include property held by a CCP as surplus collateral or close-out gains.

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"Caulking the ship": weather-proofing the legal framework for clearing services

In this article, the authors explain how the protections in Part VII of the Companies Act 1989, whilst establishing the primacy of default management processes over insolvency law, could be subject to the disruptive effects of certain proprietary claims. The article goes on to summarise adjustments to the statutory provisions, as recommended by the Financial Markets Law Committee's recent paper, which would close the loopholes and reduce systemic risk.

Part VII of the Companies Act 1989 is the cornerstone of the UK legislative framework for protecting financial markets infrastructure from legal risk. It is designed to safeguard the operation of financial markets from the impact of the insolvency, winding up or default of a party to transactions concluded on trading venues or cleared through post-trade infrastructure. It guarantees the overriding effectiveness or enforcement of certain security interests in connection with such transactions and protects certain rights and remedies over margin held, for example, with a central clearing counterparty (CCP).

One of the core provisions of this framework is s 159, which establishes that the proceedings of an exchange or clearing house are to take precedence over insolvency procedures. Broadly speaking, sub-s (1) establishes the primacy of default management processes over insolvency law and sub-s (2) provides that the powers of an office-holder, such as a liquidator or administrator, shall not be exercised in such a way as to prevent or interfere with, *inter alia*, actions taken under the default rules of an exchange or clearing house and the transfer of market contracts in accordance with those rules.

These provisions do essential work, any time a market participant becomes insolvent or otherwise fails to meet its obligations, in safeguarding the default processes of infrastructure bodies. The importance of Part VII to the smooth functioning of the financial markets should not be underestimated. A recent paper by the Financial Markets Law Committee suggests, however, that yet more could be done to weather-proof the system as it applies to CCPs.

PROPRIETARY CLAIMS

As the FMLC points out, the application of insolvency law is not the only route by which legal challenges to the default management processes of CCPs may crystallise systemic risk. Purely proprietary claims may do so too.

In *Re MF Global UK Ltd* [2012] EWHC 3415 (Ch), 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. 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$300m with which they expected to meet the liabilities to them of MFG UK. Even had MFG Inc's claim been defeated at trial, as seems most likely, a claim of this nature could have prevented the CCPs from resolving MFG UK's positions quickly and efficiently. Ultimately, it could have exacerbated the systemic impact of the default.

It is a mark of how seriously the potential impact of this claim was regarded, that three UK CCPs applied to be joined to the litigation as parties. Despite the fact that the claim settled before the issues proceeded to trial, the tremors of apprehension to which the case gave rise continue to reverberate in the legal plumbing of the financial markets today. The concern is that the protections in Part VII of the 1989 Act, while they preclude actions by office-holders and establish the primacy of default management processes over insolvency law, could yet be subject to the disruptive effects of certain proprietary claims. It would seem that the two circumstances in which such claims are most likely to arise in a clearing context are:

- on the default of a CCP clearing member (CM); and
- on the default of a client for clearing services.

These are dealt with in turn below.

CLEARING MEMBER DEFAULT

In *Re MF Global UK Ltd* [2012] EWHC 3415 (Ch) the bankruptcy trustee of MFG Inc argued that it had beneficial title to assets in MFG UK's proprietary accounts with the CCP (where MFG UK was a defaulting CM). This was, in essence, a recharacterisation claim: MFG Inc was arguing that a title transfer collateral arrangement should be recharacterised as a security interest collateral arrangement. Recharacterisation is, however, not the only context in which proprietary claims can arise. They can arise as a result of misallocation, "fat finger" errors, shortfalls and pre-existing, third-party encumbrances which were not identified by due diligence processes.

It is not just the defaulting CM's proprietary account, moreover, that is vulnerable to such claims. A CCP is obliged by Art 48 of the European Markets Infrastructure Regulation (Reg (EU) 648/2012, EMIR) to trigger procedures (known as "porting") for the transfer of the assets and positions held by the defaulting CM for the account of its clients to another CM and to do so within a predefined transfer period following the default. Assets and monies in these client accounts may be similarly vulnerable, before or after the transfer.

When a CM defaults, the documentation governing the client trade (ie the related transaction between the client and the CM) will almost certainly provide for automatic termination of that trade, too, as a consequence of the default. The CCP will, however, have contractually committed itself to transfer client assets and positions, as it is required to do by EMIR. 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 can arise in which the CCP is obliged to transfer a client position – and newly to establish a related clearing member client contract with another CM – where the initial clearing member client contract and the client trade have already both automatically terminated on their own terms. Ultimately, the new clearing member client contract will itself be resolved and, if it does not reach maturity, may itself be terminated or transferred into the transferee CM's proprietary account and offset.

From the client's perspective this situation can lead to uncertainty: the client trade has automatically terminated on its own terms but that termination has been voided by the rules of the CCP. The client – or where the client is itself in default, an incoming office-holder – may feel compelled (either with or without merit) to investigate whether it has a claim on close-out gains or collateral associated with the newly established clearing member client contract between the CCP and the transferee CM. A proprietary claim by the client or representative office-holder on assets or monies in client accounts provided by the CCP could prove highly disruptive.

Although it would be difficult to prevent such claims by clients against accounts maintained by CMs, the legal protections for infrastructure could be bolstered by closing any loopholes which would allow the client's claim to interfere with either the CCP's application of margin held against the CM's liabilities or the transfer of positions held for the account of a client. In this regard, the FMLC has recommended adjustments to the statutory provisions on:

- "notice";
- "margin [held] in relation to a market contract"; and
- "transfer".

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)

Notice, in this context, may be either actual notice or constructive notice – defined, apparently non-exhaustively, in s 190(5) of the 1989 Act. Citing a concern that a client could allege constructive notice merely on the basis of informal business conversations or a diligence questionnaire – taking place, perhaps, even before the collateral was provided – the FMLC has suggested that the definition of "notice" be restricted to actual notice for these purposes. 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, the FMLC is concerned that the scope of the provision is insufficiently generous to safeguard an application by the CCP of surplus collateral or close-out gains in an account maintained by a CM proprietary account, given the restriction (in italics above) to margin held "in relation to a market contract". In particular, the meaning of "in relation to" here is vague and may possibly allow scope for argument, whether or not the argument itself is ultimately successful. The FMLC suggests revising the subsection expressly to include the application by the CCP of property held as surplus collateral or close-out gains.

Several of the key protections offered by Part VII to a CCP's default management processes – including the protections against interference by office holders afforded by sub-s 159(2) – depend on the definition of "transfer" in s 189A, which provides in sub-s (2) as follows:

> "(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."

The FMLC has expressed a concern that these categories – although apparently non-exhaustive, which may provide scope for a wider definition than at first appears – do not clearly contemplate the situation described above in which a clearing member client contract with one CM is terminated and re-established with another CM after

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the related client trade has terminated on its own terms. Expanding the categories so as to include situations in which one of two related market contracts for clearing has already terminated when the other is transferred or re-established would close this loophole.

In the absence of additional statutory protection, there must remain a concern that the default management processes described above could theoretically be disrupted on account of a proprietary challenge brought by a client or, in the case of a defaulting client, its administrators.

CLIENT DEFAULT

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.

Following a client default, a CM may choose to transfer the client's positions from a client clearing account to its proprietary account with the CCP. It may do this to prevent positions 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.

The situation is likely to be different, however, where the defaulting client has clients of its own ("indirect clients"). Here, under European secondary legislation implementing EMIR, 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, either:

- transferring open positions to another client or CM; or
- liquidating the indirect client's positions and returning any gains or surplus.

Section 155A of the Companies Act 1989 facilitates and protects property transfers and payments of this kind by a CM attempting to deal with the default of a client.

Where the CM choses the second option, ie to liquidate the indirect client's positions and return any gains and surplus to the indirect client, it may wish to transfer the clearing member client contract relating to the client trade to its proprietary account as described above so as to offset the transaction against others. Here, gains and losses 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, may affect the monies due to the indirect clients, even where the position of the indirect clients has already been liquidated at the level of the CM.

Although arguable that a transfer of the clearing member client contract on the default of a client should be a protected transfer, it will not amount to a "qualifying property transfer", being the transfer of a position rather than of close-out gains. Nor will it qualify for the protection against interference by office holders afforded to various transfers by sub-s 159(2) of the 1989 Act. That is, not only because transfers into a CM's proprietary account are unlikely to fall within the definition of "transfer" discussed above but also because such transfers must be made in accordance with the "default rules" of the CCP and, as the FMLC observes in its paper, it is to be doubted whether the definition of "default rules" in s 188 accommodates references in a CCP's operating rules to optional transfers of this kind.

In the absence of protection, such a transfer could theoretically be open to a proprietary challenge by the defaulting client, or its administrators, of the kind referred to above. Alternatively, the indirect client may, for reasons of its own, decide to investigate whether it has a claim on close-out gains or collateral associated with the transferred clearing member client contract, notwithstanding its own trade and any associated assets and positions held at the level of the CM, have been liquidated.

A challenge of this kind would not have to offer a reasonable prospect of success to be disruptive. A CCP would likely respond to notice of the entitlement contended for by first freezing the account identified in the claim and, then, by closing it down entirely, ie by liquidating all contracts and assets on the account. Either outcome could prove disruptive and would, respectively:

- 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
- in the case of client accounts, interfere with the CCP's ability to transfer other clients' assets in accordance with regulation and its own default management processes.

The resilience of the system, therefore, might be improved were the definitions of "default rules" and "transfer" expanded to cover each of the position transfers described above, in order to safeguard the smooth and effective operation of clearing infrastructure.

BEYOND DEFAULT

As a footnote to this discussion, it is worth noting that the circumstances of default are by no means the only instance in which a client trade may be terminated and the corresponding clearing member client contract transferred. Other instances where this might occur include:

- termination of a trade by a client as a response to European regulatory measures – for example "UCITS" funds are required to be able to sell, liquidate or offset the instruments in which they invest "at any time"; and/or
- a consensual termination between a CM and a client where the CCP rules do not permit the simultaneous termination of the clearing member client contract.

Where a transfer of a clearing member client contract fails to qualify as a "transfer" for the purposes of Part VII, it may, as

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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.

CONCLUSION

The operating 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 clients. 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. Significant uncertainty would be caused by a proprietary challenge to these default management processes and by a third party claim on margin in the circumstances of a default. In light of the concerns raised by the FMLC, further consideration could usefully be given to weather-proofing the legal framework in Part VII of the 1989 Act against the legal risks posed by third party proprietary claims. ■

THE FINANCIAL MARKETS LAW COMMITTEE

The Financial Markets Law Committee (the "FMLC" or "Committee") was established in 2002 to address issues of legal uncertainty affecting wholesale financial markets. As part of its remit, the FMLC has established a number of forums for specific segments of the financial markets. These serve as space for discussion of the legal issues of interest to those market segments. The FMLC's Infrastructure Scoping Forum recommended to the Committee in 2015, that a working group should be established to examine the legal protection for central clearing in the UK. A working group was set up, chaired by Barnabas Reynolds, and recommended revisions to Part VII of the Companies Act 1989.

This article is based on the FMLC Paper entitled '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'.

For further information visit www.fmlc.org.

Further Reading:

- All the king's men: the defences of a CCP following a clearing member's insolvency [2015] 5 JIBFL 277.
- The attack of the Red Queen: a CCP's ability to defend against a cross-border challenge [2015] 10 JIBFL 618.
- LexisNexis Loan Ranger blog: All clear – clearing obligations after EMIR.