Jo Braithwaite and David Murphy
Central counterparties (CCPs) and the law of default management

Article (Accepted version) (Refereed)

Original citation:
Murphy, David and Braithwaite, Jo (2017) Central counterparties (CCPs) and the law of default management. Journal of Corporate Law Studies, 17 (2). pp. 291-325. ISSN 1473-5970

DOI: 10.1080/14735970.2016.1254448

© 2017 Informa UK Limited, trading as Taylor & Francis Group

This version available at: http://eprints.lse.ac.uk/67841/

Available in LSE Research Online: August 2017

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (http://eprints.lse.ac.uk) of the LSE Research Online website.

This document is the author's final accepted version of the journal article. There may be differences between this version and the published version. You are advised to consult the publisher's version if you wish to cite from it.
CENTRAL COUNTERPARTIES (CCPs) AND THE LAW OF DEFAULT MANAGEMENT

Jo Braithwaite and David Murphy

Keywords: Central counterparties; CCPs; clearing; EMIR; OTC derivatives; Events of Default; default management; securities; collateral.

Abstract: This article explores the legal framework around the process of ‘default management’ and explains its significance in the setting of central clearing. Having contextualised the discussion by considering central counterparties (CCPs) as default managers, and examined the safe harbours that CCPs enjoy from various provisions of insolvency law, the article considers the legal challenges arising along a ‘default timeline’ consisting of three different stages: declaration of default; close out; and collateral management. It finds that even in the context of central clearing, where robust default management is now of systemic importance to the financial system and the law is generally supportive, material risks remain and must be accounted for. The article suggests that while some of these risks may be mitigated by the parties, others require action from legislators, so addressing the fragmentary nature of the framework governing CCP default management should be a legislative priority. [150 words]
1. INTRODUCTION

This article explores the legal framework around the process of ‘default management’ and explains its significance in the setting of central clearing. It finds that, even in a context where robust default management is of systemic importance to the financial system and the law is generally supportive, material risks remain and must be accounted for.

One of the principal objectives of financial contracts is to allow creditors to manage a defaulting counterparty in a way which is effective, predictable and legally binding. One way in which this is achieved is by affording creditors a suite of contractual rights when defined ‘Events of Default’ are triggered. These events are amongst the most commonly negotiated terms of financial contracts and, as a minimum, include the non-payment of any sums due under the contract.\(^1\) While a breach of contract normally entitles the innocent party to claim for damages, an Event of Default triggers a predetermined contractual scheme allowing the non-defaulting party to take certain steps to protect itself. In the context of derivatives, for instance, this scheme will provide for early termination on the payment of a sum calculated by a method which may lead to the non-defaulting party paying the defaulter.\(^2\) To supplement these contractual protections, a creditor may take proprietary rights in its counterparty’s assets, often in the form of financial collateral such as cash or securities. These rights are

---

\(^1\) See section 3.1 infra for a review of commonly found Events of Default and the implications of this drafting.

\(^2\) As was the case in *Peregrine Fixed Income Ltd v Robinson Department Store Public Ltd* [2000] C.L.C. 1328. At [24], Moore-Bick J (as he then was) notes of this potential for payment in either direction that it ‘clearly deprives the Event of Default of most of its characteristics as a breach of contract (…) there are no doubt good commercial reasons for doing so.’
intended to be enforceable against third parties and thereby transform a creditor’s position should the counterparty become insolvent.

In practice, the rights associated with Events of Default are contingent not only on the provisions of the parties’ agreement but on a fuller and more complex set of public and private legal rules governing default management. Financial law is littered with examples where parties’ arrangements failed because such rules took precedence.³ Ex ante certainty about the law of default management is therefore vital. However, as this article demonstrates, this is becoming increasingly difficult to achieve in modern financial markets. In part this is because the applicable law is piecemeal and has been subject to significant recent change, for example as special resolution regimes have been introduced. At the same time, the process of managing a default is growing more demanding operationally, for example, sometimes requiring the non-defaulting party to close out increasingly large and complex portfolios composed of the defaulter’s positions. The ensuing tension between certainty and complexity matters for the counterparties themselves, but as we explain, there are also systemic concerns. Most pressingly, as this article will show, where regulators choose to promote safe and robust markets by requiring that certain private parties manage all the defaults that occur within a sector, this tension may have financial stability implications beyond the contracting parties themselves.

Rather than considering financial contracts in the abstract, the context for this discussion is the legal framework which applies to the default processes used in central clearing. While this is a relatively specialist context, it is important, topical and, in terms of default management, paradigmatic. Central counterparties (CCPs) intermediate all the contracts in a particular market, offering various benefits⁴ but, above all, acting as ‘default managers’ for the markets which they clear. In the wake of the global financial crisis, regulators undertook a ‘deep revision of the regulation of the securities and derivatives markets’.⁵ The resulting reform promulgated CCPs, partly because of their proven capacity to act as default managers. Specifically, new rules have been implemented in the G20 and beyond to mandate the use of central clearing for certain over the counter (OTC) derivatives.⁶

³ For example, British Eagle International Airline Ltd v Cie National Air France [1975] 1 WLR 758, HL. This case and other examples of clashes between contractual arrangements and mandatory law are discussed further in M Bridge and J Braithwaite, ‘Private Law and Financial Crises’ (2013) 13(2) Journal of Corporate Law Studies 361.
⁶ ibid, 326–336 and see infra section 2.
The ability of CCPs to manage defaulting members safely and without contagion has therefore become a matter with system-wide implications. At the same time, extensive regulatory reforms have targeted both CCPs and their members, which are predominantly banks or investment firms, and these reforms have complicated the legal framework for CCPs managing defaults. One relevant EU Regulation, EMIR, acknowledges these risks, with Article 48 requiring, amongst other safeguards, that a ‘CCP shall verify that its default procedures are enforceable.’ In sum, CCPs offer a case study in the law of default management which incorporates common legal strategies and uncommon stakes.

This article is organised as follows. As the analysis requires some background on clearing, section 2 explains how a CCP intermediates a cleared market and manages defaults, and it explores the legislative safe harbours which shield qualifying aspects of CCPs’ operations from certain legal rules. Section 3 then analyses the legal issues which arise along the course of a typical default timeline involving the declaration of default, close out and collateral management. Section 4 concludes, considering the implications of the analysis.

2. CCPs AS ‘DEFAULT MANAGERS’

The defining feature of a market which uses central clearing is that participants contract direct with the CCP rather than with each other, so that the CCP becomes buyer to every seller, and seller to every buyer. The principal advantages of central clearing arise from the CCP’s position as a hub in its market: participants no longer face the credit risk of a market counterparty; the CCP facilitates netting in the ordinary course of events; and, most

---

7 Including the special resolution regime provided for in the Banking Act 2009, discussed in section 3.1.3 infra.
8 Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, widely referred to as the European Market Infrastructure Regulation or EMIR.
9 The article focuses on English law, as this is widely used, not just by UK-based participants in the financial markets. We also consider EU law, as it applies in the UK.
10 If the defaulter is also clearing on behalf of clients, Articles 48 of EMIR obliges CCPs to ‘trigger the procedures’ for transferring or porting those positions to another member. This article does not address client clearing or porting but for a discussion of the topic, see D Turing, Clearing and Settlement in Europe, (Bloomsbury Professional 2012) and L Gullifer, ‘Compulsory Central Clearing of OTC Derivatives’ in L Gullifer and S Vogenauer (eds), English and European Perspectives on Contract and Commercial Law: Essays in honour of Hugh Beale (Hart 2014), 387-403.
11 For background on the process of central clearing generally, see D Murphy, OTC derivatives: Bilateral trading and central clearing (Palgrave Macmillan 2013); D Turing, ibid and A Rehlon and D Nixon, ‘Central counterparties: What are they, why do they matter and how does the Bank regulate them?’ [2013] Bank of England Quarterly Bulletin Q2.
importantly for these purposes, it holds financial resources allowing it to act as a shock absorber for the market if a participant fails.  

While CCPs have been a long-standing part of the financial markets, as a result of extensive post-crisis regulatory reforms they have now assumed an unprecedented role in the global economy. This transformation was triggered by the G20’s statement in 2009, following which regulators worldwide have already introduced, or are in the process of introducing, new laws requiring that eligible non-exchange traded or ‘over the counter’ (OTC) derivatives between qualifying counterparties have to be cleared through CCPs. In the EU, these reforms were implemented in 2012 by EMIR, and, in the US, by Title VII of the 2010 Dodd-Frank Act. The central objective of this clearing mandate is to reduce risk in the OTC derivatives markets. This policy outcome is, in turn, entirely dependent on CCPs being robust and being able to implement their default rules. Accordingly, the remainder of this section explains the legal nature of those rules, and considers their relationship with insolvency law.

---

12 Evidence of the ‘shock absorber’ effect in action was provided by the February 2010 evidence of LCH.Clearnet to the House of Lords EU Committee, stating that the losses caused by the failure of Lehman Brothers were covered by 35% of Lehman’s initial margin. See EU Committee, The future regulation of derivatives: Report with Evidence (HL 2009–10, 10) 93.

13 G20 Leaders’ Statement (Pittsburgh 2009) <http://ec.europa.eu/archives/commission_2010-2014/president/pdf/statement_20090826_en_2.pdf> (All websites accessed 15 June 2016, unless otherwise stated). The statement covered a package of reforms for the OTC derivatives markets, including clearing, reporting and higher capital requirements for non-cleared derivatives, of which this article only addresses the first.

14 For a summary of progress across multiple jurisdictions on the implementation of the central clearing commitment and other reforms to the derivatives markets, see Financial Stability Board, Ninth Progress Report on Implementation (24 July 2015).


16 Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) H.R. 4173 (the ‘Dodd-Frank Act’).

17 See the G20 Leaders’ Statement, n 13 supra; European Commission ‘Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories’ (Brussels COM 2010) 484/5, 6, describing the ‘final objective’ of the clearing obligation as ‘reducing risk in the financial system’, and the Recitals to EMIR, including Recital 15, explaining that the driver for mandatory central clearing is that it ‘reduces systemic risk’.

18 The objectives of the clearing mandate require a CCP itself to be robust, which explains why this reform has been accompanied by extensive reforms to the rules for the authorisation and supervision of CCPs, e.g. in Titles III and IV of EMIR. There is a large literature analysing the organisational and economic aspects of the robustness of CCPs, including discussing how to safeguard CCPs’ liquidity. These issues fall outside the scope of this article, but see for example D Murphy and P Nahai-Williamson, ‘Dear Prudence, won’t you come out to play?’ Approaches to the analysis of CCP default fund adequacy’ [2014] Bank of England Financial Stability Paper No. 30 and D Elliott, ‘Central Counterparty Loss Allocation Rules’ [2013] Bank of England Financial Stability Paper No. 20.
2.1 Default rules

Parties which face a CCP directly are known as clearing members. To become a member, applicants must meet operational and financial criteria, such as minimum net capital\(^{19}\) and members must continue to comply with these criteria throughout their membership. Due to the demands of being a member, such as providing and moving collateral on CCP deadlines, many parties wishing to clear OTC derivatives will do so as clients of clearing members rather than becoming members themselves.\(^{20}\) While there is considerable uniformity in the clearing agreements between the CCP and its members, this does not carry over to client clearing agreements. Partly for this reason, and partly for reasons of space we do not discuss client clearing further in this article.

Once accepted, the member enters into a contract with the CCP. This incorporates the clearing house’s rulebook, which details the technical processes involved in the clearing relationship. The rulebook contains the CCP’s default rules, which provide the circumstances when members can be declared in default, and the procedures which will apply once a default notice is served.

As with all contracts, there is potentially a risk that this agreement may be declared void for reasons including one party’s lack of capacity, or disrupted by vitiating factors or by claims that the terms have been varied or waived by oral agreement. In particular, the history of the bilateral (uncleared) derivatives markets has been punctuated by claims brought by non-financial counterparties that certain complex products were *ultra vires*.\(^{21}\) However, given that the membership of clearing houses is, for the moment, dominated by sophisticated financial institutions, this risk seems minimal as regards the CCP.\(^{22}\)

The more significant risk is that a member claims that its terms with the CCP have been waived or varied during a default, for example by oral statements by a CCP’s staff. This issue arose during a close-out of a sugar trader by several of its brokers, with subsequent

---

\(^{19}\) See for example, LCH.Clearnet’s membership criteria detailed at [http://www.lch.com/members-clients/members](http://www.lch.com/members-clients/members). This states that ‘LCH.Clearnet members are of high credit quality and have large financial resources.’


\(^{21}\) For example, *Hazell v Hammersmith and Fulham LBC* [1992] 2 A.C. 1 and *Haugesund Kommune v Depfa ACS Bank* [2010] EWCA Civ 579 involving, respectively, a UK borough council and a Norwegian local authority. More recently, note the unsuccessful ultra vires argument in *Standard Chartered Bank v Ceylon Petroleum Corporation* [2012] EWCA Civ 1049, [40] and the successful one in *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3101 (Comm).

\(^{22}\) However, non-financial counterparties will make up a significant part of the membership of commodities CCPs, and there are also proposals to broaden the membership of repo clearing services to include non-financial counterparties, as discussed in K Devasabai, ‘CME and LCH.Clearnet prep buyside repo clearing’ *Risk* (30 January 2015).
litigation turning on whether a conference call constituted a binding agreement by brokers to liquidate the trader’s positions in a co-ordinated way. This allegation was denied by the brokers, who had each closed-out as they thought fit. Though the Court of Appeal ultimately found that the ingredients for a binding contract were not met and therefore there was no agreement to close out in a co-ordinated way, the fact that the case proceeded so far illustrates the importance of the CCP establishing clear contractual arrangements before they are needed, and strictly adhering to them once they are.

2.2 Financial resources
CCPs hold financial resources to absorb the losses which result from a member’s default. The collection and availability of this collateral, and certainty about a CCP’s proprietary rights in these assets are fundamental to the operation of a CCP. This is reflected in the EMIR definition of clearing as ‘the process of establishing positions, including the calculation of net obligations, and ensuring that financial instruments, cash, or both, are available to secure the exposures arising from those positions’.

There are two ways which clearing members post collateral to CCPs, as margin and as default fund contributions. Margin itself has two components. Variation margin reflects the current mark-to-market value of a cleared portfolio and thus typically flows through the CCP to members which have a positive mark-to-market position with the CCP, from those with a negative position. It may be calculated daily or even intra-day. Initial margin is an additional amount required by the CCP to cover changes in value of the portfolio between the last variation margin payment and close out, to a high degree of confidence. Cash is typically

23 *ED&F Man Commodity Advisers Limited v Fluxo-Cane Overseas Limited* [2009] EWCA Civ 406. This litigation is discussed further in section 3.1 infra.

24 A short overview of a CCP’s financial resources is set out in Rehlon and Nixon, n 11 supra, 4–6. A detailed analysis of this aspect of central clearing is set out in Murphy and Nahai-Williamson, n 18 supra and the legal issues involved are analysed in L Gullifer, n 10 supra.


26 EMIR, Article 2(3) (emphasis added).

27 Clearing members are required to post margin on their own house accounts and on client accounts. CCPs’ margin requirements are passed by members on to clients, but often the clearing member can call clients for additional margin, for instance if it is troubled by the client’s credit quality.
used for variation margin and a portion of initial margin, with high quality liquid securities (as defined by the CCP) usually used for the remaining fraction of initial margin.

In addition to margin, clearing members will also contribute to a ‘pre-funded default fund’. This fund is often described as ‘mutualised’ because the contributions of all of the members are available should the losses on the default of a particular member exceed its own contributions. While the levels of margin and default fund required from members are part of each CCP’s design, there are minimum standards laid down in EMIR and in accompanying Regulatory Technical Standards. The default fund, for instance, must be sufficient to enable the CCP to ‘withstand, under extreme but plausible market conditions, the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members, if the sum of their exposures is larger.’ CCPs often also make some of their own capital available to absorb any losses above a clearing member’s margin and default fund contribution (which is called having ‘skin in the game’).

Overall, there is a ‘default waterfall’ of financial resources which are available to absorb the losses of a defaulting member. The CCP must use these resources in the order prescribed by EMIR, namely, starting with margin posted by the defaulting member, then the default fund contribution of the defaulting member, followed by a measure of the CCP’s own resources and then the default fund contributions of the non-defaulting members. There may then be additional ‘unfunded’ resources available, such as the right for the CCP to call for additional default fund contributions or to haircut (or discount) variation margin gains before passing them on to members. Where all such resources are exhausted, a CCP risks

---

28 An exception is contingent variation margin arrangements where instead of variation margin flowing through the CCP from losers to those in the money, credits and debits are made to a net margin account at the CCP. Crucially if the total (initial plus variation) flow on a given day is positive, i.e. the CCP owes the relevant account money, then this remains as a credit, without cash actually being paid. For more detail on the use of cash and on the banking arrangements underpinning its transfer to CCPs by members, see J Braithwaite and D Murphy, ‘Got to be certain: The legal framework for CCP default management processes’ [2016] Bank of England Financial Stability Paper number 37.

29 For more detail on the use of securities as collateral, and in particular on the implications of the intermediated nature of modern securities, see section 3.3 infra.

30 As regulated by EMIR, Article 42.

31 For example, in Murphy and Nahai-Williamson n 18 supra, 4.

32 Commission Delegated Regulation (EU) 153/2013 of 19 December 2012 supplementing EMIR with regard to regulatory technical standards on requirements for central counterparties

33 EMIR, Article 42(3), as expanded upon by Chapter VII of Commission Delegated Regulation (EU) 153/2013 of 19 December 2012 supplementing EMIR with regard to regulatory technical standards on requirements for central counterparties.

34 The principal requirements as regards the default waterfall are set out in EMIR, Article 45 as expanded upon by Chapter IX of Commission Delegated Regulation (EU) 153/2013 of 19 December 2012 supplementing EMIR with regard to regulatory technical standards on requirements for central counterparties.
insolvency, although CCP resolution regimes are under development. In recognition of these risks, CCPs are required to have in place recovery plans or ‘living wills’.

### 2.3 CCPs and insolvency law

One, but not the only, reason that clearing members default is that they are insolvent or heading that way. As a result, a CCP may have to manage a default concurrently with an insolvency regime. This section discusses the extent to which this may constrain a CCP in practice.

In England, there are numerous insolvency regimes which might apply to a failing or failed company. One analysis has suggested that a company incorporated as a bank in England could be subject to any one of eleven different types of insolvency procedure. We focus here on formal insolvency proceedings, which are either an administration or a winding up. The primary objective of an administration is ‘rescuing the company as a going concern’ and the administrators are, in the ordinary course of events, to act in the interests of the company’s creditors as a whole. As an administration is designed to provide breathing space for the company, it imposes a moratorium on insolvency proceedings (i.e. the company cannot be wound up in this period) and on other legal processes, including on the enforcement of security over the company’s property without the permission of the court or the administrator. This differs from winding up, or liquidation, which involves gathering in the company’s assets for distribution to creditors and shareholders, followed by the dissolution of the company.

---


38 See D Turing n 10 supra, 161. Turing’s eleven types do not include creditors’ schemes of arrangement (Companies Act 2006, s 895) or the special resolution regimes under the Banking Act 2009.

39 Insolvency Act 1986, s 3(1) of Schedule B1, as added by the Enterprise Act 2002, which created the current regime for administrations. Section 3(1) includes other objectives, being (b) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration) and (c) realising property in order to make a distribution to one of more secured or preferential creditors. Sections 3(3)–(4) make it clear that these objectives are in order of priority.
If these formal insolvency regimes applied wholly and concurrently during the default of a clearing member, CCP default management would be much harder and more uncertain than it is. Even though the Australian case of Ansett Australia Holdings Ltd v IATA confirmed the robustness of the fundamental structure of a clearing house upon insolvency of a member, a CCP’s particular contractual and proprietary rights as regards its failing member would still be difficult or impossible to apply if insolvency law were to take precedence. This is principally because formal insolvency regimes put the insolvency practitioner in charge of many aspects of the defaulter’s business in ways which would disrupt the CCP’s own management of the default. For instance, mutual set-off would be overseen by the insolvency practitioner rather than the CCP. Certain of the defaulter’s contracts with the CCP might also be disclaimed, set aside or declared void. Transactions entered into by the defaulter in a prescribed window before the onset of insolvency may be vulnerable to being set aside, under the rules applying to preferences, undervalued transactions, and floating charges. Given a CCP’s reliance on collateral, the powers of an administrator over charged property would also be problematic. For example, the administrator could potentially apply to court for permission to dispose of property that is subject to a charge other than a floating charge. The court must be satisfied this would ‘be likely to promote the purpose of administration in respect of the company’. The administrator may also dispose of property that is subject to a floating charge without the need to go to court.

These risks are mitigated, however, by statutory ‘safe harbours’ which provide special treatment under insolvency law for certain classes of financial transactions, and for certain market participants. They typically prevent the disruption of private arrangements for close out, netting and the provision of collateral. As Paech has documented, they have been implemented worldwide on the basis of their effects on systemic risk, and because they

---

40 Ansett Australia Holdings Ltd v IATA. [2008] HCA 3 (HC). See also British Eagle v Compagnie Nationale Air France n 3 supra. The much discussed majority House of Lords decision in British Eagle held that an arrangement between airlines for multi-lateral netting without novation to a central counterparty was invalid on the insolvency of one of the participants, as the law required the set off of mutual debts. This risk has been addressed in clearing house structures where contracts are entered into with the CCP, and the robustness of this arrangement on insolvency has been confirmed by the later case of Ansett. See further, M Bridge, ‘Clearing Houses and Insolvency’ (2008) 2 Law and Financial Markets Review 418.
41 Insolvency Rules 1986, Rule 4.90
42 Insolvency Act 1986, s 239.
43 Insolvency Act 1986, s 238.
44 Insolvency Act 1986, s 245.
45 Insolvency Act 1986, paras 70 and 71 of Schedule B1, addressing floating charges and other types of charges, respectively.
increase market liquidity.\textsuperscript{46} Such is their importance to the market that safe harbour regimes have become ‘fairly homogenous from a global perspective’,\textsuperscript{47} so, for example, the International Swaps and Derivatives Association (ISDA) noted that, as at early 2010, 37 countries had enacted legislation allowing the enforceability of close-out netting.\textsuperscript{48} This homogeneity successfully supports the ‘cross-jurisdictional use of assets on the present [global] scale’.\textsuperscript{49} Some commentators, nonetheless, regard these safe harbours as controversial because they question the benefits\textsuperscript{50} or because of concerns about the influence of powerful, non-state actors on public rule-making.\textsuperscript{51}

CCPs benefit from one of the most extensive sets of legislative safe harbour provisions found anywhere in the financial system. While much of this regime pre-dates the 2008 financial crisis, the introduction of the clearing mandate following the G20’s 2009 statements have provided further, powerful justifications based on the fact that CCPs have been co-opted to safeguard the stability of the post-crisis financial markets. Indeed, it is a prerequisite of this part of the regulatory response to the financial crisis that CCPs are able to apply their default rules in a predictable way, as it would be self-defeating if the public sector were to allow insolvency laws to weaken one of the principal financial stability measures.

Under English law, CCP safe harbours have several different legislative sources. The overall effect is supportive of CCPs operations generally, and of default management specifically. Nonetheless, a detailed audit of these rules, set out in section 3.1.2 infra,\textsuperscript{52}

\begin{footnotesize}
\textsuperscript{46} For a further discussion of the rationale for the ‘privileged treatment arising under insolvency safe harbours’, see P Paech, ‘The Value of Financial Market Insolvency Safe Harbours’ (2016) Oxford Journal of Legal Studies 1. He argues that of the two classic rationales for safe harbours—increasing liquidity and decreasing overall systemic risk—the former is the more significant and harder to challenge.

\textsuperscript{47} ibid 5.

\textsuperscript{48} ISDA, The Importance of Close-out Netting (2010) ISDA Research Notes No. 1. 2.

\textsuperscript{49} Paech, n 46 supra, 30, a transnational effect also vividly documented in A Riles, Collateral Knowledge (University of Chicago Press 2011).

\textsuperscript{50} The most comprehensive attack on financial contract ‘immunities’ including safe harbours for close-out netting is in R Mokal, ‘Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts’ (2015-2016) 10 Brooklyn Journal of Corporate, Financial and Commercial Law 15. Mokal argues that safe harbours are counterproductive, based on a purportedly flawed and false understanding of systemic risk, and that they cannot be explained on any basis other than the path dependency of policy-makers. See also R Bliss and G Kaufman, ‘Derivatives and Systemic Risk: Netting, Collateral, and Closeout’ (10 May 2005) Federal Reserve Bank of Chicago WP2005-03, which questions whether close-out netting reduces systemic risk. In a variation on this line of criticism, Levitin argues that the mutualisation of risk is preferable to safe harbours from a systemic risk perspective, and submits that insolvency safe harbours should therefore be repealed in favour of mandatory clearing for systemically important financial contracts. A. Levitin, ‘Prioritization and Mutualization: Clearinghouses and the Redundancy of the Bankruptcy Safeharbours’ (2015-2016) 10 Brooklyn Journal of Corporate, Financial and Commercial Law 129. Contrast, however, the related debate about whether the ability of CCPs to reduce systemic risk has been overstated. See, for example, C Pirrong, ‘The Clearinghouse Cure’ [Winter 2008–9] Regulation 4 (focusing on mandatory clearing for credit default swaps) and M Roe, ‘Clearinghouse Overconfidence’ (2013) 101 California Law Review 1641.

\end{footnotesize}
demonstrates that the fragmentary and sometimes inconsistent protections can be problematic.

The most comprehensive set of safe harbour rules for CCPs is found in Part VII of the Companies Act 1989 (‘Part VII’). This important statute sets out extensive safeguards for CCPs, expressly protecting market contracts, market charges and market property from specific provisions of insolvency law, and also providing, at section 159, a general disapplication of insolvency law where it conflicts with market contracts and the default rules of recognised clearing houses (amongst other exemptions). Part VII is the most prominent source of legislative protections and other legislative support for CCPs’ operations, including its default rules. However, it is not the ‘cure all’ it is sometimes taken for; it is by no means designed to exempt all activities of a CCP from all conflicting law. Rather, Part VII should be seen as being reinforced by various other legislative provisions.

There are two main sets of legislation which supplement Part VII to protect a CCP’s default management processes. The first is the Financial Markets and Insolvency (Settlement Finality) Regulations 1999/2979 (‘SFR’), which implement the Settlement Finality Directive 1998/26/EC. The Directive aims to provide a consistent Europe-wide treatment of the process of settling a financial transaction, including where one of the system’s participants becomes insolvent. The SFR apply to designated ‘systems’, and it is now a requirement of Article 17(4) of EMIR that any authorised CCP has to be designed a ‘system’ for this purpose.

Regulation 14 of the SFR sets out the principle that the proceedings (broadly defined, and including ‘default arrangements’) of a designated system will take precedence if inconsistent with insolvency law; later regulations disapply specific provisions of the Insolvency Act. Importantly, there is specific modification of the law of insolvency with respect to a ‘collateral security charge and the actions taken to enforce such a charge’.

---

52 Broadly defined in Part VII, s 155 and including contracts between a recognised clearing house and its members.
53 Defined in Part VII, s 173 as a ‘charge, whether fixed or floating, granted … in favour of a recognised clearing house, for the purpose of securing debts or liabilities arising in connection with their ensuring the performance of market contracts …’
54 Addressed in Part VII, s 177, which covers margin in relation to a market contract or default fund contribution.
55 ‘Default rules’ is defined by Part VII, s 188 of and this definition is discussed further in section 3.1.2 infra.
56 These other exemptions relate to the settlement of market contracts not dealt with under default rules, and porting of client positions and assets on the default of a member.
57 Part VII principally facilitates a recognised clearing house’s default proceedings by modifying insolvency law. However, Part VII also assists default proceedings in other ways, e.g. section 160 imposes a duty to assist with a recognised clearing house’s default proceedings on any person who has or had control of the defaulter’s assets, or who has or had documents relating to a defaulter.
58 SFR, Regulation 18.
The second piece of legislation which supplements and extends Part VII’s support for CCPs’ operations, as already noted, is the Financial Collateral Arrangements (No.2) Regulations 2003/3226 (‘FCAR’) which implement the Financial Collateral Arrangements Directive 2002/47/EC. This Directive seeks to harmonise rules for the creation, perfection and enforcement of financial collateral across the EU, and increase legal certainty about such arrangements. The FCAR apply to both security interest and title transfer collateral arrangements over ‘financial collateral’. This is defined as ‘cash, financial instruments or credit claims’, so it covers nearly all of a CCP’s collateral, whether posted as margin or default fund contributions. The FCAR contain a number of helpful disapplications for CCPs. Notably, Regulations 4, 5, 6 and 7 disapply certain formalities, such as the registration of charges, while Regulations 8 to 11 disapply certain insolvency rules. This disapplication of insolvency law is broader than that found in Part VII or the SFR. In particular the FCAR are the only of the three legislative regimes to disapply section 176A of the Insolvency Act 1986. Furthermore, this is the only framework of the three which expressly applies on the insolvency of the collateral provider or taker (as expressly set out in Regulation 10(1)). Given the pivotal role played by financial collateral in their safe operation, CCPs must take care to ensure that their arrangements enjoy these important protections. Particular areas of risk are considered in section 3.3 infra.

2.4 Conclusion

If market participants did not default, there would be no need for CCPs. CCPs deploy detailed contractual procedures, backed up with financial resources, in order to manage defaults safely and prevent contagion to the rest of the market. The importance of this function of CCPs has been heightened by regulatory reform the wake of the last financial crisis, justifying CCPs’ special legislative treatment. Part VII and the SFR, coupled with the more general provisions of the FCAR, combine to create a supportive, if piecemeal, regime for CCPs’ default management processes. Against this background, the following section evaluates the extent to which material risks remain, whether from shortcomings in safe harbour legislation, or from other types of legal challenge.

59 Each term is separately defined in FCAR, Regulation 3.
3. LEGAL ISSUES ALONG A DEFAULT TIMELINE

3.1 Declaration of default
The declaration of clearing member default lays the foundation for the procedures which follow, and certainty is therefore paramount. An incorrect or inaccurate declaration may compromise the CCP’s own actions and, because it could trigger cross-default provisions in other contracts, or discourage other parties from dealing with the member, or possibly tip a member into insolvency, it might also expose the CCP to a sizeable claim for damages.

There are three principal challenges for the CCP at this stage which, respectively, involve contractual interpretation, careful navigation of the relevant legislative provisions, and awareness that the right to call an Event of Default may be stayed if a member is affected by a special resolution regime. The following explores these issues in more detail.

3.1.1 Contractual compliance
Typically, the Events of Default defined in a CCP’s membership agreement will include non-payment of any sums due from the member, a breach of the agreement, the initiation of insolvency procedures variously defined, and regulatory action being taken against the member. Such lists are often supplemented by ‘catch-all’ terms. For example, the CCP may be allowed to call a default if it is ‘necessary or desirable for our own protection’ or in the event of the member ‘appearing to the Clearing House to be unable, or to be likely to become unable, to meet its obligations in respect of one or more Contracts’. It is also common for Events of Default to include grace periods, notice periods and other formalities which must be observed before a default can be declared.

The declaration of default may appear to be a simple step, however, the litigation around the close out of Fluxo-Cane Overseas Limited’s positions in exchange traded sugar derivatives demonstrates that there can be pitfalls. In one of several English cases concerning

---

60 A cross-default clause in contract X means that if a borrower defaults on other financial indebtedness it will also be a default under X. In practice, these clauses are heavily negotiated and vary as to materiality thresholds, de minimis amounts, grace periods and so on.
62 Sucden v Fluxo-Cane Overseas Limited [2010] EWHC 2133 (Comm) at [44(4)].
63 Section 3, LCH.Clearnet Default Rules, March 2016 version, n 61 supra.

14
these events. Fluxo-Cane argued that one of its brokers had prematurely begun the liquidation of its positions at a time when it had no right to do so. After a lengthy review of the Terms of Business between the parties the judge ultimately found that the broker was not entitled to rely on the most obvious Event of Default in this case (the non-payment of margin) because the contract required the failure to pay to continue for ‘one Business Day’ from Fluxo-Cane being given ‘notice of non-performance’. As this period had not elapsed before the broker took action to liquidate the positions, there was not a valid Event of Default on this ground at the relevant time. Though the broker stated in court that ‘the only default that he had in mind at the time of sending out the default letter was non-payment of margin’, it also contended that there were in fact other valid Events of Default at the relevant time. However, a number of attempts to point to a valid Event of Default also proved unsuccessful. For instance, an Event of Default for non-payment of indebtedness when due was also held not to be triggered at the time that the liquidation started, with the judge finding that it would be wrong to allow this clause to bypass the notice provisions in the non-payment of margin Event of Default. Similarly, the judge held that the broker could not rely on a cross-default clause, which it had submitted was triggered by findings in a parallel case between Fluxo-Cane and another broker. This, the judge held, would lead to too much ‘commercial uncertainty’.

The broker was saved, however, by the judge’s finding that other Event of Defaults had been triggered before liquidation commenced. The first valid Event of Default was the term covering the situation where Fluxo-Cane ‘disaffirms, disclaims or repudiates any obligations under the agreement’. The judge held this happened at a meeting between Fluxo-Cane and its brokers before the liquidation commenced. The second was a broad term which allowed the broker to close out if ‘necessary or desirable for our own protection’. However, before being able to rely on either Event of Default, the broker had to persuade the judge that it did not matter that they were not expressly relied upon at the time of the liquidation. This argument succeeded, but with the judge noting the ‘exceptional’ circumstances of this close out.

---

64 Sucden, n 62 supra. English litigation also included ED & F Man v Fluxo-Cane Overseas Limited [2010] EWHC 212 (Comm) and Marex Financial Limited v Fluxo-Cane Overseas Limited [2010] EWHC 2690 (Comm). There was also concurrent litigation in New York.

65 Sucden, n 62 supra, at [35] and [36].

66 ibid at [44(2)].

67 ibid at [44(3)].

68 ibid at [44(4)].

69 ibid at [44(7)].
This narrow victory demonstrates that, even where standardised contract terms may be in use, it can be very difficult to observe notice and grace periods as a default actually unfolds. It also shows that cross-default clauses may not help as anticipated. In this light, a CCP would be well-advised to minimise or standardise drafting providing for notice periods and, secondly, to ensure that its ‘fire drills’ practise these aspects of declaring defaults. The primary purpose of Events of Default is to allow the CCP to act with speed and certainty, and this objective will be wholly undermined if the foundational step is called into dispute.

3.1.2 Statutory safe harbours: Defaults, coverage and inconsistencies

It is not enough that the CCP has valid contractual grounds to call an Event of Default. Given the likelihood that a defaulting member will be insolvent, or near-insolvent, it is also important that the CCPs’ actions fall within the available statutory protections from insolvency law. To an extent, this turns on the grounds on which the default has been called in the first place. The issues here are delicate not least because, perhaps surprisingly, there is no consistent definition of the term ‘default’ in the relevant legislation. If a particular CCP procedure does not qualify as a ‘default rule’ (or equivalent) then it important that it qualifies as another type of protected procedure.

The discussion below shows that each of the four main legislative provisions relevant to CCPs uses different definitions and, to an extent, different approaches, when framing their respective rules around ‘defaults’.

(1) Part VII

Section 188 of Part VII defines ‘default rules’ as the rules

of a recognised clearing house which provide for the taking of action in the event of a person (including another recognised clearing house) appearing unable, or likely to become unable, to meet his obligations in respect of one or more market contracts connected with the … clearing house.

The term is also defined to include the default procedures referred to under Article 48 of EMIR (see below) and actions the CCP takes under default procedures in Article 4(4) of the Regulatory Technical Standards in respect of client clearing.\(^{71}\)

\(^{71}\) Article 4(4) of Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing EMIR with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation,
above, however, Part VII does not only cover default rules. For example, the general modification of insolvency rules also extends to ‘the rules of a … recognised clearing house as to the settlement of market contracts not dealt with under its default rules’, and rules of a recognised clearing house relating to the transfer of client contracts (i.e. if a member fails).

The Part VII definitions are expressly adopted elsewhere. For example, Section 7 of the Banking Act (Restriction of Partial Property Transfers) Order 200972 adopts various definitions from Part VII, including ‘default rules’. This disappplies those parts of the Banking Act 2009 which give the Resolution Authorities powers to make partial property transfers from a failing bank or other type of financial institution in resolution, avoiding conflict with CCPs’ default rules.

(2) SFR

The SFR use the term ‘default arrangements’, which are defined by Regulation 2(1) as arrangements
to limit systemic and other types of risk which arise in the event of a participant … appearing to be unable, or likely to become unable, to meet its obligations in respect of a transfer order, including, for example, any default rules within the meaning of Part VII … or any other arrangements for – (a) netting, (b) the close out of open positions, (c) the application or transfer of collateral security; or (d) the transfer or assets or positions on the default of a participant in the system.

This definition therefore includes, but is broader than, ‘default rules’ under Part VII. As a result, a procedure may qualify as a ‘default arrangement’ but not as a ‘default rule’ under Part VII.

As with Part VII, the SFR protect more than just default arrangements. The pivotal regulation in this respect is Regulation 14 (which sets out the principle that the ‘proceedings’ of a designated system will take precedence if inconsistent with insolvency law). Regulation 14(1) expressly lists the contracts covered by this provision, including ‘a transfer order’, ‘the default arrangements of the designated system’, ‘the rules of a designated system as to the settlement of transfer orders not dealt with under its default arrangements’ and ‘a contract for the purpose or realising collateral security in connection with participation in a designated system or in a system which is an interoperable system in relation to that designated system

72 S.I. 2009/322.
otherwise than pursuant to its default arrangements.’ This broad drafting could therefore apply proceedings falling outside of the definition of default arrangements.

(3) FCAR
The FCAR do not expressly mention default rules or default procedures, but they are vital to both. As mentioned, they protect ‘financial collateral arrangements’, defined in Regulation 3(1) as either a security financial collateral arrangement or title transfer financial collateral arrangement over ‘financial collateral’ (defined as cash, financial instruments or credit claims). The risks around qualifying under these definitions are discussed in section 3.3 infra.

(4) EMIR
Perhaps surprisingly, given their importance to CCPs, EMIR also does not define either ‘default’ or ‘default rules’. Article 48(1) suggests that ‘default procedures’ are ‘procedures to be followed if a clearing member does not comply with the participation requirements of the CCP ‘laid down in Article 37’. This is a relatively narrow definition, as Article 37 refers to ‘non-discriminatory, transparent and objective’ admissions criteria, which will not cover all of the Events of Default that some CCPs might wish to have, such as those anticipating potential future events which have not yet crystallised.

In any event, there are no general safe harbours for default procedures in EMIR. A narrow protection is set out in Recital 64, which indicates that if a member defaults, the EMIR requirements on segregation and porting, designed to protect the clients of the defaulting member ‘should therefore prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them’.73 Thus, there is coverage for client segregation and porting but not for CCP default procedures generally.

In sum, the main legislative protections relevant to CCPs differ in terms of what is protected, what is disapplied, and how protections are achieved. Most strikingly, the three sets of legislation which expressly refer to a CCPs’ contractual and proprietary rights on a default offer varying degrees of coverage, with the SFR definition being the broadest, and EMIR the

---

73 Implemented into law in the UK by amendments to Part VII.
narrowest. In such a sensitive area of law, such inconsistency is undesirable as it may lead to delay and uncertainty.

There are also more specific concerns about these definitions. Most importantly, in both Part VII and the SFR, the definitions of ‘default rules’ and ‘default arrangements’ (respectively) require that the defaulter is unable or likely to become unable to meet its obligations to the CCP. Both definitions therefore cover narrower sets of rules than the default rules as they will be defined by some CCPs’ membership agreements. This gap may be significant in practice. For example, as the 2008 collapse of Lehman Brothers demonstrated, a group’s ultimate parent can fail at a time when some other members of the group, including subsidiaries which are clearing members of CCPs, show no signs of being in breach of their obligations. At this point, a CCP may have the contractual right to call an Event of Default. If it did so, the ensuing default processes would appear to fall outside the definitions of default rules and default arrangements. To benefit from the important safe harbours in both sets of legislation, the CCP would have to show that the rules it was relying upon fell into another protected class, for example because they related to ‘the settlement of market contracts not dealt with under its default rules’. At the very least, the narrowness of the statutory drafting, compared to the breadth of a CCP’s terms, means that different default processes will be treated differently under the same legislation. This requires parties to keep close track of complex legislation during this first stage of a default.

3.1.3 Special resolution regimes and Events of Default

For reasons mentioned above, members of CCPs are predominantly banks and investment firms.74 Most CCP members therefore fall under one of the various, recently implemented special resolution regimes. These regimes have, to an extent, been designed to give CCP’s default rules precedence,75 but in some circumstances, they will restrict a CCP’s right to declare an Event of Default.

For UK firms, the Bank of England (as Resolution Authority) has very broad powers under the Banking Act 2009 and the Investment Bank Special Administration Regulations

---

74 CCPs publish membership lists, for example, LCH.Clearnet’s lists are published on its website at <http://www.lch.com/members-clients/members/current-membership>
75 As discussed infra, and noted in the discussion of ‘default rules’ under Part VII in section 3.1.2 supra.
which it can use to manage ailing financial institutions. These include stabilisation tools, such as the power to bail-in liabilities, or to transfer of some or all assets and liabilities to an asset management vehicle, bridge bank, or other purchaser. As a last resort, HM Treasury may transfer the institution to temporary public sector ownership. These powers enable the Authorities to leave ‘bad’ assets and liabilities behind, separating them from the ‘good’ ones being transferred. This could disrupt contracts between the failing bank and its counterparties, including contracts expressly designed to protect the counterparty in such circumstances (e.g. through netting), although no creditor worse off safeguards are intended to limit the extent of the potential disruption and to provide appropriate compensation in some circumstances.\textsuperscript{77}

These resolution powers have been disapplied in some of the cases where they may clash with the rights of a CCP. The limits on the resolution powers in this context include, first, that, The Bank of England may not make a partial property transfer order with respect to the failing entity if this would modify or make unenforceable the default rules of a recognised clearing house, or rules for the settlement of market contracts by a recognised clearing house.\textsuperscript{78} Secondly, temporary stays under section 70A of the Banking Act 2009 may not be used by the Bank of England to stay the rights of CCPs, because CCPs constitute ‘excluded parties’ for this section.

The special treatment for CCPs is not absolute, however. Importantly, CCPs are not excluded from the effects of section 48Z of the Banking Act 2009 which expressly limits when a non-defaulting counterparty (i.e., the CCP) may call an Event of Default. This section means that where a clearing member falls under the special resolution regime, the CCP cannot call an Event of Default just because the member is in resolution, or because the authorities have taken another form of ‘crisis management measure’ or ‘crisis prevention measure’, or because a recognised third-country resolution action has been taken with respect to the member, or because of any event ‘directly linked’ to such a measure. This restriction only applies, however, where the member’s ‘substantive obligations continue to be performed’.\textsuperscript{79} The meaning of ‘substantive obligations’ is therefore pivotal in this context, but

\begin{footnotesize}
\begin{enumerate}
\item S.I. 2011/245
\item The Banking Act (Restriction of Partial Property Transfers) Order 2009. See supra text to n 71, explaining that the definition of default rules for this purpose follows Part VII.
\item Banking Act 2009, s 48Z(5).
\end{enumerate}
\end{footnotesize}
the term is not fully defined. Instead, it is characterised as ‘including payment and delivery obligations and provision of collateral’ (emphasis added).80

This limitation on CCPs’ contractual rights tracks wording in the Banking Recovery and Resolution Directive,81 and is necessary in order to protect the workings of the new resolution regime. It is problematic, however, that these rules do not provide clear guidance in several respects. First, it is unclear what, if any, further contractual obligations might count as ‘substantive’. The word ‘including’ clearly suggests that the list in the statute of payment, delivery and provision of collateral is not definitive, but it is not obvious which of the other obligations in the contract (e.g., to abide by other membership criteria) might qualify. Further, the two illustrations given in the statute suggest that certain obligations are objectively ‘substantive’, so that parties would not be able to define ‘substantive obligations’ for themselves. However the opposite may be suggested by other wording in regulation 3(1A)(b) of the FCAR, and similar wording in section 48Z, which refers to ‘substantive obligations provided for in that agreement’ (authors’ emphasis).82 This might lead to an inquiry into the parties’ intentions in each case.83 At the very least, a CCP should ensure that the failure to meet each of the substantive obligations listed in this statute are included as Events of Default, so that as soon as the defaulting party failed to meet them, the CCP would have the right to declare a default at the same time as the stay under section 48Z expired. This would be cleaner than having to argue that a right to declare the original Event of Default was stayed at the time, but was now no longer suspended.

Section 48Z and the equivalent drafting in the FCAR are part of the special resolution regime and not captured by the modifications of ‘insolvency law’ for CCPs in the safe harbours discussed above. The result is that a CCP’s default procedures would, under certain conditions, have to give way to the special resolution regime. This is a significant development for CCPs and an important qualification to their otherwise extensive protections from conflicting law. Having a member in special resolution will therefore present an unfamiliar set of circumstances for a CCP. The CCP may have to take advice on the

---

80 This section is mirrored, though not word for word, in 2010 amendments to the FCAR in a new definition of ‘enforcement event’ at Regulation 3(1A), inserted by the Bank Recovery and Resolution (No. 2) Order 2014/3348, sch.3(3) para.9(2)(b).
82 This is the FCAR wording. Section 48Z(5) refers to ‘substantive obligations provided for in the contract or agreement …’
83 Cases from other sectors suggest that such inquiries can be controversial and generate much market interest. In recent shipping cases, it has been held that a term providing for punctual payment of the charter was an innominate term, rather than a condition. See Spar Shipping AS v Grand China Logistics Holdings (Group) Co Ltd [2015] EWHC 718 (Comm).
definition of ‘substantive obligations’ as events unfold, and then act promptly if and when such obligations cease to be met.

3.2 Close out

Once a default is declared, Article 48 of EMIR states that a CCP must

  take prompt action to contain losses and liquidity pressures resulting from defaults and shall ensure that the closing out of any clearing member’s positions does not disrupt its operations or expose the non-defaulting clearing members to losses that they cannot anticipate or control.

In other words, the CCP has to close out the defaulter’s cleared portfolio, while managing its own risks and liquidity and containing the effects of the default.

‘Close out’ is a standard feature of both cleared and uncleared derivatives contracts.

As Gloster LJ explained in Videocon Global Ltd v Goldman Sachs International

[t]he purpose of these [close out] provisions is to provide a contractual mechanism for (a) calculating the amount due upon the (early) termination of multiple transactions – as a single payment due from one party to another; and (b) facilitating the prompt payment of such amount.84

The attraction of close out provisions is that the parties agree in advance how the contract may be valued and terminated once a default happens, thereby avoiding the need to wait for a breach and then sue for damages or other remedies.

There are very detailed contractual provisions to this effect in the 1992 and 2002 ISDA Master Agreements, the terms and interpretation of which helpfully informs the position for CCPs.85 The 1992 version allows the parties to choose from two methods of valuation, namely ‘Market Quotation’, where the valuation is based on quotations from Reference Market Makers, or ‘Loss’, where the non-defaulting party reasonably determines its losses or gains in good faith. The 2002 Master Agreement replaces these two definitions with a single, more flexible, method of valuation called the ‘Close-out Amount’. While there is little case law on the latter, as Briggs J put it, a ‘significant body of recent case law has developed in relation to the interpretation and application both of Loss and Market Quotation

84 Videocon Global Ltd v Goldman Sachs International [2016] EWCA Civ 130, at [4].
85 The ‘scheme’ of the 1992 ISDA Master Agreement is described in detail in Lomas v JFB Firth Rixson [2012] EWCA Civ 416, at [12] while the revised close out provisions in the 2002 ISDA Master Agreement are described and compared to the 1992 version in The Joint Administrators or Lehman Brothers International (Europe) v Lehman Brothers Finance SA [2013] EWCA Civ 188 (hereafter ‘LBIE v LBF’), at [12]–[25].
under the 1992 Master Agreement. Close out by CCPs has not yet been subject to scrutiny in the English courts, and so the extensive case law on the ISDA terms provides important insights into the types of challenges that a CCP may face from a defaulting member.

### 3.2.1 Interpreting contractual close out provisions

Case law on the ISDA Master Agreement shows that the close out process may prove to be contestable, even where very detailed schemes are provided in the contract. This is especially likely where a default unfolds in dysfunctional market conditions.

Challenges of this kind will often come down to interpreting the parties’ contractual language. In the English courts, the process of contractual interpretation takes its starting point the exact words of the parties’ agreement. Words (such as ‘conditions precedent’, ‘material terms’ and ‘option rights’) are given their natural meaning, unless this is clearly not the intention of the parties. Where words have more than one potential meaning, the court’s task is to ‘ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant.’ ‘Background knowledge’ in this context is widely drawn, and has been held to include ISDA’s User’s Guide, which was discussed in detail by the Court of Appeal in *LBIE v LBF*. The commercial context of the parties’ transaction is also factored in, thanks to the principle that where there is more than one possible meaning, the court should prefer that which ‘is more consistent with business common sense’. As a result, the commercial purpose of the contract as a whole is more significant than a ‘[d]etailed semantic analysis’ of particular words. For instance, in a dispute about whether the effects of automatic early termination should be left out of the calculation of the Close-out Amount under the 2002 ISDA Master Agreement, the fact that this valuation lead to an ‘uncommercial result is a factor that militates against it being the right interpretation.’

---

86 *Anthracite Rated Investment (Jersey) Ltd v Lehman Brothers Finance SA (in liquidation)* [2011] EWHC 1822 (Ch) at [116]. In the same part of the judgment Briggs J (as he then was) reviews various ‘propositions’ about the 1992 terms on Loss and Market Quotation which have emerged from this body of case law.

87 Though see discussion in section 3.2.3 infra of the interim application in *Re MF Global (in special administration)* [2015] EWHC 2319 (Ch) where the background facts referred to close out by a CCP.

88 As interpreted in *LBIE v LBF*, n 85 supra, at [71]–[95].

89 *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900, per Lord Clarke at [21].

90 *LBIE v LBF* n 85 supra at [20]–[21] and [107].

91 *Rainy Sky SA* n 89 supra, applied, inter alia, in *LBIE v LBF*, n 85 supra at [65].

92 *In re Sigma Finance Corporation* [2010] 1 All ER 571, at [37] per Lord Collins.

93 *LBIE v LBF* n 85 supra, at [68].
While many different details of the ISDA Master Agreement’s close out scheme have been considered by the English courts, one controversy is particularly relevant for CCPs. This is the debate about which factors the non-defaulting party must, and must not, take into account during the close out when it calculates the value of its contract with the defaulter.

In relation to the 1992 ISDA Master Agreement, the English courts have established the principle that the non-defaulting party should value the transaction on a ‘clean’ basis, meaning that it should assume, for valuation purposes, that the transaction would carry on to maturity and that each ‘condition precedent’ would be met. To some criticism, ‘condition precedent’ in this context has been interpreted widely. In effect, this means that a range of problems on the defaulter’s part have been ruled to be irrelevant to the valuation process. In ANZ v Société Générale, a non-defaulting party calculating Loss could not take into account the fact that, had the agreement not been terminated, the defaulter’s condition would have allowed the non-defaulting party to make future payments using an alternative method, which was more favourable from its perspective. In Britannia Bulk v Bulk Trading, the Court of Appeal held that the non-defaulting party calculating Loss could not take into account the fact that, had the contract continued, its counterparty would have been insolvent and therefore its right to be paid suspended under section 2(a)(iii) of the ISDA Master Agreement. However, based on amendments included in the 2002 ISDA terms, the Court of Appeal held that the value clean principle does not apply in the same way to this later version of the agreement. In a case arising out the collapse of Lehman Brothers group, this meant that the effects of a side letter to the derivatives deal could be taken into account for the purposes of valuation. This case also demonstrates the vast sums which may be at stake in disputes about close out. In LBIE v LBF, had the side letter not been factored into valuation, the close out sum payable by LBIE would have increased by approximately $1 billion.

It can be seen that even where the valuation stage of close out is covered by very full, technical drafting it does not preclude uncertainty and challenges in practice. From the

---

94 For example, the central issue raised by Videocon Industries Ltd v Goldman Sachs International [2016] EWCA Civ 130 was whether Goldman Sachs had, according to the terms of the 1992 Master Agreement, validly served notice of the sum to be paid on early termination. Dismissing the appeal, and after a long analysis of the relevant contractual provisions, the court found that it had.

95 See, for example, Norton Rose Fulbright LLP, ‘Derivatives close-outs – Recent case law’ (April 2014), describing various recent decisions upholding the value clean principle as ‘controversial’ and stating that it has ‘[u]nfortunately’ upheld by decisions including Lomas v JFB Firth Rixson [2012] EWCA 419, where the issue was the subject of the fourth appeal considered in this judgment. Available at <http://www.nortonrosefulbright.com/knowledge/publications/114271/derivatives-close-outs-recent-case-law>

96 [2000] 1 All ER (Comm) 682.

97 The fourth appeal in Lomas v JFB Firth Rixson n 95 supra.

98 LBIE v LBF n 85 supra.
perspective of CCPs, these ISDA Master Agreement disputes have a dual significance. On the one hand, they serve as a warning about the potential for challenges; on the other hand, this case law and the principles developed by the English courts should help CCPs design their own documentation and default processes in order to minimise such risks.

3.2.2 Reasonableness
A non-defaulting party closing out a derivatives contract may also face a challenge that it has not acted in a way that is reasonable. A challenge may be based on express contractual wording, i.e., where the agreement expressly requires actions to be ‘reasonable’, or on the common law duty to exercise discretion in a reasonable, or rational, way.

The term ‘commercial reasonableness’ is used in both versions of the ISDA Master Agreement. The 1992 version requires that parties using the Market Quotation measure of close out amount switch to the alternative measure, Loss, if the former is unobtainable or ‘would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result.’ The 2002 version uses commercial reasonableness in two ways: the party closing out must use commercially reasonable procedures and these must produce a commercially reasonable result.

Peregrine Fixed Income Ltd v Robinson Department Store Public Co Ltd considered ‘commercial reasonableness’ under the 1992 Master Agreement. Robinson, the non-defaulting party, calculated the amount payable on close out using the Market Quotation method. It determined $9.7 million was due to Peregrine, which had entered into liquidation. The nominal value of the loss to Peregrine was $87.3 million. Peregrine objected that the Market Quotation method lead to a result that was ‘commercially unreasonable’. The judge agreed that, even though Robinson honestly believed its valuation to be reasonable, it did ‘not produce a commercially reasonable result.’ The judge found that Robinson could not properly have reached the conclusion that its valuation was reasonable, taking all the relevant factors (such as the divergence with the Loss measure) into account. This approach was based on Associated Provincial Picture Houses Ltd v Wednesbury Corp. The well-known ‘Wednesbury test’ requires that parties act honestly, in good faith and not arbitrarily,
capriciously or unreasonably. It followed that Robinson, in using Market Quotation rather than Loss, acted unreasonably and in breach of contract.

The same test informs a different type of challenge to the close out process, based on the common law rather than express contractual language. A principle has emerged in the common law that, where a contract gives one party discretion to take a decision which affects the other, the decision-maker must exercise its discretion in a reasonable or ‘rational’ way. This has been held to mean that the party’s discretion is limited, again following Wednesbury, by an implied term that it would not be exercised ‘dishonestly, for an improper purpose, capriciously or arbitrarily’. As reflected in recent case law, this principle is particularly relevant in the close out context because a determining party will usually be required to exercise discretion at several different points in the process.

In one line of cases addressing non-defaulting parties’ duties during close out, the courts have described the implications of this test as follows. There are ‘parameters’ defining the range of values which might be arrived at if the valuation exercise is conducted ‘honestly and rationally’ and within those parameters the valuing party ‘is entitled to have an entirely proper regard for any danger to itself from valuing too optimistically’. In other words, subject to this duty of rationality, the decision is that of the valuing party, not the market or the court. Euroption v SEB confirmed that the valuing party could act in their own interests rather than the defaulter’s. Here, the court found that a reasonable person acting reasonably could have closed-out as SEB did, even though this did not maximise value for Euroption. The judge emphasised that it was not the job of the court to re-run the close out process to second guess what might have been done differently. That said, there have been examples of valuations falling outside these parameters. In WestLB AG v Nomura Bank International Plc, Nomura’s valuation was found to be ‘irrational’.

---

105 Paragon v Nash [2001] EWCA Civ 1466 at [103]; Socimer v Standard Bank ibid at [66].
106 See WestLB AG v Nomura Bank International Plc [2012] EWCA Civ 495, at [60].
107 See for instance Socimer v Standard Bank n 104 supra, at [112]
dealers what was in the relevant portfolio. It received no bids. The court proceeded to determine what the outcome of a rational valuation process would have been.\footnote{In fact, the ‘portfolio of mainly unquoted and exotic stocks and shares, at a time of a historic “credit crunch”’ was found to have no value ‘other than at most a 5% hope value’: \textit{WestLB AG v Nomura Bank International Plc} \textit{n 106 supra, at [61]}.}

The duty of rationality should therefore be seen by CCPs as a standard to be observed whenever exercising discretion, which will be inevitable during a close out. In particular, it should be carefully factored in where the CCP is closing out in unprecedented or otherwise challenging market conditions. However, the standard should not ordinarily be unduly onerous to meet. It does not prevent a CCP from acting in its own interests when closing out, and nor does it allow the court to second-guess the process. In short, if a CCP complies with its contractual obligations and exercises its discretion in a way that is ‘honest and rational’, it is fully entitled to protect its own interests during the default management process and a challenge based on the duty of rationality seems unlikely to be successful.

\subsection{3.2.3 CCP-specific issues}

In addition to the general challenges considered above, there are several specific issues arising in the context of a close out by a CCP.

First, section 184 of Part VII gives CCPs an indemnity for liability for loss or damage from specified acts. For instance, Section 184(3) protects CCPs and their officers and employees from liability in damages for anything done or omitted ‘in the discharge or purported discharge’ of ‘…its default rules’, but there is a proviso, ‘unless the act or omission is shown to have been in bad faith’. Bad faith includes, but is broader than dishonesty, and has been described in a different context as including ‘sharp practice’ which may fall short of ‘outright dishonesty’\footnote{\textit{Nira Battery Manufacturing Co} v \textit{Milestone Trading Ltd} [2002] 2 All ER (Comm) 705, 741 at [135], per Moore-Bick LJ. For a discussion of good faith and contract law, see J Beatson and D Friedman (eds), \textit{Good Faith and Fault in Contract Law} (OUP 2007) and for a valuable discussion of the meaning of bad faith, in the context of explaining it as a limit on the change of position defence to restitutionary claims based on mistaken payment, see E P Elllinger and others (eds), \textit{Ellinger’s Modern Banking Law} (5th edn, OUP 2011), 533–534.}. As with commercial reasonableness, transparency and good record-keeping of default management decisions and executions will assist here.

Secondly, one of the rare CCP-specific cases from the English courts demonstrates the court’s reluctance to intervene in close outs conducted in compliance with the CCP’s rules. \textit{Re MF Global UK Limited}\footnote{[2015] EWHC 2319 (Ch).} involved an application under section 236 of the Insolvency Act 1986 brought by joint special administrators of MF Global UK Limited. The respondents were two clearing houses which had closed out MF Global’s open positions
‘very shortly’ after the appointment of administrators. The purpose of the application was to force disclosure so that the administrators could consider if there were grounds for bringing proceedings. The case was made more complex by extra-territorial aspects, but essentially the court held that difference between the close out prices and screen quotations for the same positions one day later was not something that warranted being investigated further. In particular, it was not sufficient to justify the administrators’ far-reaching request for information about the close out.

Thirdly, a special feature of close out by CCPs is that a CCP’s terms may provide for an auction of the defaulting member’s positions. A successful auction will establish a close out valuation and find another member to take on the defaulter’s contracts. Auctions are a relatively new feature of CCPs’ default management processes and CCPs usually retain the flexibility to organise them in a variety of ways. In some cases, for example, members may be incentivised to provide good bids by rules stating that, after the auction, should there be losses to meet from the default fund, the contributions of members who have not submitted acceptable bids will be used before those of members who have.\textsuperscript{113} CCPs also sometimes organise auctions where they have discretion about who can participate. As with other aspects of close out, therefore, a CCP will have not only to comply with the terms of its agreement with members and but also exercise its discretion in a rational way, as discussed above.

3.3 Collateral management

If, after the close out process outlined above, the CCP faces losses caused by the default of a member, it will seek to recover them by using the available financial resources, starting with the defaulter’s collateral. Despite the safe harbours in Part VII, the SFR and the FCAR, complexities and some risks in this process remain. This section discusses the forms of collateral accepted by CCPs and then examines three areas of concern around the use of this collateral, explaining how CCPs may respond.

3.3.1 Forms of collateral

Cash and high quality securities are the standard forms of margin accepted by CCPs.\textsuperscript{114} Cash is typically provided by members to the CCP using a title transfer. This means that outright


\textsuperscript{114} See supra section 2.2 for an explanation of ‘margin’. 
ownership of the cash is transferred, with the member having a contractual right to redelivery of agreed amounts when its debt is discharged. The underlying technical arrangements for the transfer of cash are relatively simple: cash is posted to the CCP by book entry, often by using a ‘concentration bank’ where both member and CCP hold accounts. In this case, the clearing agreement will often give the CCP the right to make a debit transfer from the member’s account direct.

The legal and operational issues surrounding the use of securities as collateral are more complex. Modern securities are held in electronic and, therefore, intermediated form.115 In English law, the concept of a trust is normally used to characterise the links in the custody chain between the central securities depositary, custodians, sub-custodians and the ultimate investor.116 As Gullifer puts it, describing the use of the trust to analyse these tiers of intermediaries, the ‘position in English law is an example of the use of existing concepts’.117 The use of the trust means that an investor’s interests in securities will be held by its custodian as trustee for the investor, and so on along the chain.118 This intermediated chain of interests in securities complicates the provision of collateral. There are a number of models of posting interests in securities to clearing houses depending on the collateral type and the collateral agreement. One common one is shown in Figure 1, where the CCP has an account at the central securities depository (‘CSD’), the clearing member’s custodian also has an account at the CSD and the clearing member posts the securities as collateral by instructing its custodian to transfer the securities into the CCP’s account.

116 The definitive account of the legal relationships in intermediated securities holdings, and in particular the role of trust law therein, is still found in J Benjamin, *Interests in Securities* (OUP 2000).
117 Gullifer, n 115 supra, 230.
Further complexity is added to the intermediated chain by commingling and segregation. The former arises where a custodian holds securities in a commingled client account: here the accepted legal analysis is that clients in this position will be equitable tenants in common of the interests in the commingled account. The trust relationship therefore survives commingling, but in practice, each client will be vulnerable to shortfalls caused by losses attributed to other clients, so-called ‘fellow client risk’. By contrast, ‘segregation’ is used to describe arrangements where client assets are held or recorded separately from the trustee’s own or ‘house’ assets and sometimes also (depending on the nature of the segregation) from the assets of other clients. Degrees of commingling and segregation affect each level of the intermediated chain. For example, in the CCP context, an interest in a security may be segregated at the level of the custodian’s books but not at the depositary level. Furthermore, many CCPs now offer clients a menu of different options as to how their securities will be held, which are more nuanced than the choices required by Articles 39(2) and (3) of EMIR. One option, widely used in the US, is a ‘legally separated but

---

119 This model only works where the CCP can open an account in its own name at the CSD and it can settle securities into that account. If that is not possible or practical, it may need its own settlement bank and custodian. The EMIR regulatory technical standards require that if a CCP can use the CSD direct, it must.

120 For an analysis of commingling, see M Yates and D Montague, The Law of Global Custody (Bloomsbury Professional 2013) sections [3.42]-[3.55]. They characterise the custody relationship, following Hunter v Moss and Re Stapylton Fletcher Ltd, as one where the custodian holds assets in a commingled client account and the clients are equitable tenants in common, with the custodian acting as their trustee. (Hunter v Moss [1994] 1 WLR 452 and Re Stapylton Fletcher Ltd [1994] 1 WLR 1181). This is consistent with Brigg J’s description of the holding of securities in Re Lehman Brother International (Europe) [2009] EWHC 2545 (Ch). For a discussion of shortfalls specifically, see Gullifer, n 115 supra, 245–252.

121 The FCA’s Client Assets Sourcebook (CASS) rules apply to ‘firms’ holding client money or assets. These rules do not apply to CCPs directly, so they are not considered further in this article. However, they may affect those CCP members which clear for clients, so there will be an indirect effect on CCPs, and this is reflected in the drafting of CASS. For further discussion of amendments to CASS to take account of clearing, see J Braithwaite, ‘Legal Perspectives on Client Clearing’ [2015] LSE Law, Society and Economics Working Paper 4.

122 EMIR, Articles 39(2) and (3) require that a CCP shall offer ‘omnibus client segregation’ and ‘individual client segregation’ respectively.
operationally commingled’ (‘LSOC’) model. Other options offer full segregation for the assets of members, or even for the individual clients of members. One CCP explains that, in this case, specific assets are ‘tagged’ to an individually segregated account. The main attraction here is that, should a client’s CCP member fail, its assets could be ‘ported’ or transferred to a solvent member with more speed and certainty than if those assets were in a commingled client account.

The combination of intermediation and various degrees of commingling and segregation along the chain of interests in securities creates a complex, if reasonably efficient, system of securities holding. In this context, careful drafting of collateral arrangements between CCP and member is required to ensure that both parties enjoy exactly the rights they intend to rely upon. The various risks examined next are particularly noteworthy in this context.

3.3.2 Fixed and floating charges

A CCP may take either a fixed or a floating charge over a member’s financial collateral. The defining feature of the latter is the chargor retains control over the collateral until such point as the charge ‘crystallises’ or fixes to the asset, for example on a default. Until then, the chargor may sell, lease, dispose of, or otherwise deal with the asset. This contrasts with a fixed charge, where the chargor requires the chargee’s consent to deal with the charged asset.

There is a risk, which is more acute where the collateral consists of intangible assets such as intermediated securities, that a court may recharacterise a collateral arrangement as a floating charge. This can happen even when the parties’ agreement gives the charge a

---

123 The LSOC was adopted by the Commodity Futures Trading Commission (CFTC) by the following rule, which also discusses in detail the benefits of the LSOC model compared to other types of segregation: 77(25) Fed. Reg. 6336 (February 7, 2012).


125 This was one of the three characteristics of the floating charge set out in Re Yorkshire Woolcombers Association Ltd [1903] 2 Ch D 284, confirmed as the defining characteristic by the House of Lords in Re Spectrum Plus [2005] 2 A.C. 680, at [95]–[111]. This latter decision established that the ‘essential characteristic of a floating charge’ is ‘that the assets subject to the charge is not fully appropriated as security for the performance of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security.’ Ibid at [111], per Lord Scott.

126 For a detailed analysis of the differences between fixed and floating charges, see L Gullifer and J Payne, Corporate Finance Law: Principles and Policy (2nd ed, Hart 2015), section 7.3.3.3.
different label, for example calling it a fixed charge or even a ‘lien’.

Such recharacterisation matters for several important reasons. Insolvency rules put a floating charge holder at a disadvantage compared to the fixed charge holder because they are less senior in the order of creditors. The proceeds of the assets subject to the floating charge will be used to pay the expenses of the liquidation or administration, then preferential creditors, and then a ‘prescribed part’ in favour of general creditors before then paying the floating charge holder. Floating charges can also be set aside by an insolvency administrator in some cases. Furthermore, there are long-standing difficulties around the FCAR’s coverage of floating charges and, should a particular floating charge not qualify under the FCAR, it will not be covered by the FCAR’s disapplication of certain insolvency legislation and it may be void for non-registration.

The FCAR expressly protect ‘security financial collateral arrangements’, which are defined in Regulation 3(1) as involving, inter alia, the creation of a ‘security interest’ where the financial collateral is ‘in the possession or under the control of the collateral-taker or a person acting on its behalf…’ The same Regulation defines a ‘security interest’ as ‘including pledges, mortgages, fixed charges and ‘a charge created as a floating charge’. This definition confirms that in the case of a floating charge, the financial collateral must ‘be in the possession or under the control of the collateral-taker or a person acting on its behalf …’ To date, two cases have considered how this requirement works in the context of a floating charge, though both considered the language as it stood before a 2010 amendment, which is discussed further below. The two cases are *Gray v G-T-P Group Ltd* and *Re Lehman*

---

127 In *Re Lehman Brothers International (Europe) (In administration)* [2012] EWHC 2997 (Ch) the parties’ agreement stated that the chargor was providing a ‘lien’ over intermediated securities but this arrangement was recharacterised as a floating charge. More commonly, the cases have seen fixed charges recharacterised as floating, see, e.g., *Re Spectrum Plus* [2005] 2 A.C. 680, where the charge was described in the parties’ documentation as ‘specific’ which here was intended to mean ‘fixed’, as described at [79].

128 The immediate issue at stake in *Re Spectrum Plus* was whether the bank holding the charge would rank before or after preferential creditors. Under Insolvency Act 1986, s. 175 a fixed charge would see the chargee bank paid before the preferential creditors, but a floating charge would mean that the preferential creditors (the Inland Revenue, etc.) have their claims met before the bank. *Re Spectrum Plus*, ibid at [76].

129 Insolvency Act 1986, s 176A. The priority of liquidation or administration expenses over preferential claims is provided for by s 176ZA, and preferential claims dealt with by s 175.

130 Under Insolvency Act 1986, s 245, floating charges created in the run-up to insolvency are set aside, unless for new value. Moreover under paragraph 70 of Schedule B1 of the same Act, an administrator has the power to dispose of floating charges without the leave of the court. See Gullifer and Payne, n 126 supra.

131 Including under FCAR, Regulation 10.

132 Qualifying security financial collateral arrangements are exempted from certain formalities including the requirement to register a charge under the Companies Act 2006; FCAR, Regulation 4.

133 [2010] EWHC 1772 (Ch).
Brothers International (Europe) in administration\textsuperscript{134} and in both, the floating charges in question were held to fall outside the FCAR. The former case was a short hearing on a relatively low value matter, though, in a sign of the importance of this issue in practice, the decision still provoked extensive market concern.\textsuperscript{135} The latter case involved a more lengthy hearing including extensive submissions from counsel on the substantive law and as a result, the judgment offers a comprehensive analysis of the legislation and of the background to it. This decision diverged from Gray in that in the Lehman case, Briggs J held that it was technically possible to have ‘possession’ of intangible assets such as interests in securities for the purpose of the FCAR.\textsuperscript{136} In Re LBIE, the charge in question, having been recharacterised as a floating charge, was held to fall outside the FCAR because of a lack of ‘possession or control’ by the collateral taker. This was the case even though the collateral was held in an account in the name of the collateral taker, because of the extent of the powers that the collateral provider had to withdraw it (or in the judge’s words, ‘do what it liked with the property’\textsuperscript{137}) without reference to the liabilities owed by the collateral provider.

After amendments in 2010,\textsuperscript{138} regulation 3(2) of the FCAR defines ‘possession’ to include the situation where the collateral is put in an account in the name of the collateral taker, but this definition is subject to an unhelpful proviso: ‘provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral.’ This definition has been criticised for being too vague, in particular about the extent of the powers that a collateral provider may retain to decide what is ‘excess’ collateral before ‘possession’ is lost.\textsuperscript{139} Indeed, looking \textit{obiter} at these amendments in the Lehman case, Briggs J commented that ‘[c]ritics of the outcome and analysis in Gray may be forgiven for

\begin{itemize}
\item \textsuperscript{134}n 127 supra. This case was heard after the FCAR amendments, but considered the unamended FCAR, as noted by Briggs J: ‘… it is the FCARs in their original form which is material for present purposes.’ \textit{Re LBIE}, ibid at [83].
\item \textsuperscript{135}For example, the Financial Markets Law Committee called it ‘an unwelcome precedent at a crucial time.’ FMLC, ‘Issue 87—Control: Gray v G-T-P Group Ltd’ (December 2010), at [4.13]. Available at \texttt{<http://www.fmlc.org/uploads/2/6/5/8/26584807/issue87_fmlc_paper_decemeber_2010.pdf>}
\item \textsuperscript{136} \textit{Re LBIE} n 127 supra, at [131].
\item \textsuperscript{137} ibid at [147].
\item \textsuperscript{138} The Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010/2993, which came into force in April 2011, added the new definition of ‘possession’.
\item \textsuperscript{139} See Gullifer and Payne, n 126 supra, section 7.3.4.2. Note that in \textit{Re LBIE} n 127 supra this issue of ‘excess’ was complicated by the fact that LBF had created a charge in favour of LBIE with respect to sums owed by LBF to LBIE and to LBIE’s affiliates.
\end{itemize}
having thought that this proviso gave with one hand but took as much away with the other.’ 140 Professor Gullifer agrees that ‘the scope of the FCARs still remains unclear’. 141

The first European Court of Justice decision on the EU financial collateral regime is pending at the time of writing. The matter concerns the validity of a bank’s charge over cash deposited in a customer’s current account. The Opinion of Advocate-General Szpunar was delivered with respect to this case in July 2016 and, on ‘possession’ and ‘control’, it confirms that the meaning of the terms is ‘problematic’. 142 Citing Gray and Re LBIE, the Advocate General agrees with the line taken by the English courts that ‘being in the possession or under the control of the collateral taker must mean that the collateral taker not only has practical control over the account to which the collateral relates, but also has the right to prevent the withdrawal of cash by the collateral provider in so far as is necessary to guarantee the necessary obligations.’ 143 In the absence of such ‘legal control’, the arrangement in question would therefore fall outside the financial collateral regime, as the Advocate General indicated was likely in the matter before the ECJ on this occasion. 144

In practice, if intermediated securities remain in an account in the name of the CCP at the CSD (as illustrated in (Figure 1) supra) and the member only has the right to substitute or withdraw ‘excess’ collateral, which is defined in the contract, 145 without the permission of the taker, the risk of a floating charge falling outside the FCAR will be minimised. On the other hand, if the member retains more extensive rights over the collateral, this may introduce uncertainty on this very important point.

### 3.3.3 Conflicts of law

Intermediated securities often introduce different jurisdictions into what may already be a cross-border transaction, and they thereby intensify the conflict of law issues which have to be managed by a CCP. The absence of a consensus about how to work out which law applies to intermediated holdings in securities, coupled with the lack of consistency between

---

140 Re LBIE n 127 supra, at [126].
141 L Gullifer n 10 supra, 380.
142 Private Equity Insurance Group SIA v Swedbank AS Case C-156/15, Opinion of Advocate General Szpunar (21 July 2016), at [43]. This case concerns the EU Directive 2002/47/EC on financial collateral arrangements, which was implemented in the UK by the FCAR.
143 ibid at [51].
144 ibid at [52].
145 Gullifer and Payne comment that there is an argument that parties should have freedom of contract to define ‘excess collateral’ for themselves, but the limits to what they can agree remain unclear. Gullifer and Payne, n 126 supra, 314.
domestic laws, creates legal uncertainty and, potentially, risks around the enforcement of a CCP’s rights.

The default rule for property rights is that the applicable law will be that of the place where the property is located (lex situs). This rule is straightforward to apply with traditional forms of securities. For bearer instruments, for example, the governing law would be the law of the physical location of the securities. The situation is not straightforward, however, where there is a chain of interests in securities represented by book entries in accounts, and this problem continues to command a good deal of attention from stakeholders.

One approach to this problem that has gained traction in financial markets legislation is ‘PRIMA’, or the application of the law of the ‘place of the relevant intermediary account’. This approach determines the law of each link in the intermediated holding chain by looking at the relationship between account holder and account provider. The PRIMA approach was adopted by the Hague Conference,146 and in slightly different form by the FCAR and the SFR.147 It ensures that only one law governs securities in each account. The shortcomings of the approach, however, include that it may be difficult to agree where an account is maintained in some cases, and that different governing laws will apply to different parts of the chain of interests in securities. Moreover, choice of law rules such as PRIMA do not harmonise the underlying substantive laws, so they do not ensure that a given process is treated in the same way in all jurisdictions.148 There has, of course, been some progress on harmonisation of substantive law relating to securities at an EU level. The FCD has achieved regional harmonisation of rules relating to collateralisation, further underlining the point made above that it will be very important to ensure that a CCP’s collateral arrangements are covered by this regime. Moreover, while UNIDROIT developed the Geneva Convention on Substantive Rules for Intermediated Securities to address many of the issues we have discussed,149 it has not yet been signed by any states apart from Bangladesh. Therefore,

146 Hague Conference on Private International Law, Convention on the law applicable to certain rights in respect of securities held with an intermediary (2006). The convention has not been signed by any members of the EU.
147 See in particular FCAR, Regulation 19, where it is referred to as the ‘standard test’, and SFR, Regulation 23. The PRIMA test in this legislation differs from that in the Hague Convention where the law of the account is the law agreed by the parties (Hague Convention, Article 4 (Primary rule)). In the FCAR and SFR, the law of the account is the law of the country where the relevant account is maintained, or (for SFR purposes) where the register or central deposit system is maintained.
despite some regional progress, the substantive rules governing interests in securities remain fragmented, creating the potential for incompatibility and uncertainty.

3.3.4 Notice and knowledge

A CCP’s rights over collateral may also be compromised by its notice or knowledge of certain facts, for example, if it is aware that a member is using client assets as its own or of other breaches of duty along the intermediated chain. A CCP may, as a result, find itself liable to third parties (e.g., the clients of clearing members) for personal and proprietary claims.

‘Notice’ determines ‘whether a person takes property subject to or free from some equity’. In particular, in this context, if assets transferred to the CCP were the traceable proceeds of misused client funds and if the CCP had notice of the wrongdoing, the client may have a proprietary remedy against the financial resources held by the CCP. Notably, the test for having notice is broader than actual notice, i.e., a party may have constructive notice of a fact where it failed to make the proper inquiries ‘suggested by the facts at his disposal’.

The consequences of ‘knowledge’ are different, but also potentially severe, as it may mean that a party is held personally liable as a constructive trustee. For a CCP, it may lead to liability for knowing receipt, which is established where the defendant beneficially receives property (such as financial collateral) disposed of in breach of fiduciary duty and has knowledge that the assets it received are traceable to such a breach. A CCP in this case would be liable to compensate the beneficiary (e.g., the client of the member) for its losses from the member’s breach of trust. As the client’s claim against the CCP would be a personal one, it would not matter if the CCP no longer had the assets in question. Further, a CCP may, in extreme circumstances, become liable for dishonest assistance. This does not require the CCP to have received the assets in question, but requires that the CCP was accessory to or

---

150 *Re Montagu’s Settlement Trusts* [1987] Ch 264, 278 per Sir Robert Megarry V-C, defining and distinguishing ‘notice’ and ‘knowledge’.

151 In practice, while there is extensive case law on this issue, it will be a matter of fact in each case. As Lord Sumption put it in a recent Privy Council decision finding that a bank did have constructive notice of impropriety, these questions ‘are often highly sensitive to their legal and factual context’. *Crédit Agricole Corporation and Investment Bank v Papadimitriou* [2015] UKPC 13. Professor Bridge notes, however, that the courts have been reluctant to ‘to import the doctrine of constructive notice in to commercial dealings’ [footnote omitted]. M Bridge, Personal Property Law (4th ed, OUP 2015), 225.

152 The elements of knowing receipt were set out by Hoffmann LJ in *El Ajou v Dollar Land Holdings plc* [1994] 2 All ER 685, 700. The question of knowledge proved controversial in the case law, but it does not require dishonesty. It was held by the Court of Appeal in *BCCI v Akindele* [2001] Ch 437, 455 per Nourse LJ, that the ‘recipient’s state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt.’ See the analysis of this test in the financial context in Ellinger’s Modern Law of Banking, n 111 *supra*, 295–299.
assisted with the member’s breach of trust and is deemed to have been ‘dishonest’, which, after Twinsectra v Yardley\(^{153}\) and the Privy Council’s decision in Barlow Clowes International Ltd v Eurotrust International Ltd,\(^{154}\) is a ‘predominantly objective’ test.\(^{155}\) This liability would also lead to a personal claim to make good the clients’ losses.

Statutory safe harbours may also be compromised by a CCP’s notice or knowledge. The carve-out of the indemnity for CCPs’ actions for ‘bad faith’ has already been noted above.\(^{156}\) Various other parts of Part VII are also qualified if the CCP has notice of certain facts. Section 177 of Part VII, for example, states that a CCP may apply margin ‘notwithstanding any prior equitable interest or right, or any right or remedy arising from a breach of fiduciary duty unless the … clearing house had notice of the interest, right or breach of duty at the time the property was provided as margin.’ The SFR disapply the notice provisions of sections 163, 164 and 175 of Part VII, but this only applies to a) ‘a market contract which is also a transfer order through a [CCP]’ and b) ‘a market charge which is also a collateral security charge.’ Part 177, however, is not disapplied.

These types of claims have not yet been raised before the English courts in the CCP context.\(^{157}\) However, the clearing mandate will increase the use of client clearing, and with it CCPs’ potential exposures to clients as third parties. Given the potential severity of the consequences, awareness of these types of claims is therefore important for CCPs.

4. CONCLUSION

It is difficult to imagine a more systemically important context for default management than central clearing, especially in light of the clearing mandate being implemented in the G20 and beyond. Against this background, drawing out the issues which arise along a timeline of a clearing member’s default enables us to evaluate the applicable law in a rigorous and constructive way. The picture which emerges is of a generally supportive, but in some

\(^{153}\) [2002] 2 AC 164 (HL)

\(^{154}\) [2006] 1 All ER 333 (PC).

\(^{155}\) Described as such in Abou-Rahmah v Abacha [2007] 1 Lloyd’s Rep 115, at [66] and [94], discussed in Ellinger’s Modern Banking Law n 11 supra, 286.

\(^{156}\) There is also an indemnity under Part VII, s 184(1), which applies to actions relating to ‘property of a defaulter’, but this is limited to where the CCP ‘believes and has reasonable grounds for believing that he is entitled to take this action’.

\(^{157}\) Though the question of CCPs’ notice has been raised by a commentator discussing a case which was settled before trial, which concerned the ownership of T-bills transferred intra-group between US and UK entities and then posted by the UK entity to various clearing houses. A Lenon QC, ‘An unresolved collateral issue: Re MF Global UK Ltd and the ownership of US Treasury Bills posted as margin’ [July/August 2014] Butterworth’s Journal of International Banking and Finance Law 433, 434 discussing the preliminary hearing Re MF Global UK Ltd [2012] EWHC 3415 (Ch).
respects, fragile legal framework which has been further complicated by extensive post-crisis regulatory reforms, including new rules imposing the clearing mandate, reforming the insolvency and resolution regimes, and overhauling the regime for the governance of CCPs. The analysis above also demonstrates how this legal framework is variously affected by developments in different parts of the financial system. In some respects, as in the case of the implied duty of rationality, case law from other sectors opens up new risks for CCPs. In other respects, such as in the design of close out valuations, CCPs may draw valuable lessons from more battle-tested markets.

Ultimately, we have shown that even in a context where parties are highly sophisticated, deploy standard terms, draw on case law from other markets and enjoy some of the most extensive safe harbours in the financial system, there remains the potential for legal challenge on various grounds. CCP default management procedures are, after all, a complex part of a complex industry. As we have explained, some challenges may be mitigated by the parties’ careful drafting, for example of collateral arrangements over intermediated securities, of Events of Default notice periods, and of the CCP’s right to exercise discretion. Further, CCP ‘fire drills’ should include operational details such as giving appropriate notice because by so doing, CCPs will mitigate some of the legal pitfalls associated with the basic contractual aspects of default management.

Other challenges, however, are for legislators. These challenges arise primarily because the legislation governing this aspect of the financial market infrastructure has become highly piecemeal. The diverse definitions of default rules, the meaning of ‘substantive obligations’ for the purpose of the stays of contractual rights during resolution and the gaps in the financial collateral regime remain matters for law-makers to address, and for CCPs and their members to navigate as vigilantly as possible in the meantime.