

## **MEMORANDUM OF LAW**

**prepared for**

**LCH LIMITED**

**in respect of**

**the validity and enforceability of the clearing documentation of  
LCH Limited under the laws of England & Wales**

9 MARCH 2023

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## 1. INTRODUCTION

We have been asked by LCH Limited (“**LCH**”) to prepare this memorandum of law (the “**Memorandum**”) to address the questions presented in Section 5 below pursuant to the laws of England & Wales (the “**Relevant Jurisdiction**”).

In preparing this Memorandum:

- (a) we have only reviewed the documents listed in Section 2 below; and
- (b) we have relied on the assumptions set out in Section 3 below.

In addition, this Memorandum is subject to the limitations and qualifications set out in Section 4 below.

Please note that all references in this Memorandum to EU-derived and directly-effective EU legislation should, unless specified otherwise, be understood as references to such legislation as it forms part of UK domestic law by virtue of the European Union (Withdrawal Act) 2018, as amended (the “**EUWA**”), and as amended from time to time in accordance with UK law.

## 2. LCH AGREEMENTS

In preparing the Memorandum, we have reviewed the following documents (together, the “**LCH Agreements**”):

- (a) LCH’s General Regulations dated 12 December 2022 and Procedures (“**Rulebook**”);
- (b) LCH’s Default Rules dated 20 September 2022 (“**Default Rules**”);
- (c) LCH’s Settlement Finality Regulations dated 3 December 2021 (the “**Settlement Finality Regulations**”);
- (d) LCH’s template Clearing Membership Agreement (“**CM Agreement**”);
- (e) LCH’s template Deed of Charge (“**Deed of Charge**”); and
- (f) LCH’s template Security Deed (“**Security Deed**”).

Capitalised terms not otherwise defined herein have the meanings ascribed to them in the LCH Agreements. Any provisions of this Memorandum which refer to the “execution” of the LCH Agreements refer only to the CM Agreement, the Deed of Charge and the Security Deed, as applicable.

## 3. ASSUMPTIONS

In preparing this Memorandum we have made the following assumptions:

- (a) LCH is a private company limited by shares incorporated under the laws of England and Wales and with its registered office and primary place of business in London;
- (b) LCH is at all relevant times a recognised central counterparty within the meaning of Section 285 of the Financial Services and Markets Act 2000, as amended (“**FSMA**”).

and a “designated system” for purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (“**SF Regulations**”);

- (c) each of LCH’s clearing members addressed in this Memorandum (each, a “**Relevant Clearing Member**”) is an entity:
  - (i) authorised under Part 4A of FSMA to accept deposits, other than an entity who is limited to accepting deposits in the course of carrying on an insurance business for which the person is properly authorised or a credit union as defined in Section 31 of the Credit Unions Act 1979 (each, a “**UK Bank**”);
  - (ii) an investment firm as defined in Section 258A of the Banking Act 2009 (“**BA 2009**”) (each, a “**UK Investment Firm**”);
  - (iii) a building society formed and registered under the Building Societies Act 1986 (“**BSA 1986**”) or otherwise deemed registered thereunder (each, a “**UK Building Society**”);

in each case that is a company either formed and registered under the Companies Act 2006 (“**CA 2006**”) (or the “former Companies Acts” as defined therein) or incorporated by royal charter but does not, for the avoidance of doubt, include any company incorporated in Scotland or that was formed and registered under the “former Companies Acts” from a location that no longer forms part of the United Kingdom; or

- (iv) organised or incorporated and regulated as a bank or an investment firm in another jurisdiction but operating through a branch located in this jurisdiction (a “**UK Branch**”);
- (d) LCH and each Relevant Clearing Member are duly formed and, at all times, are validly existing and organised under their respective jurisdiction of organisation or incorporation;
- (e) LCH and each Relevant Clearing Member have the capacity, power and authority, under all applicable laws, to enter into and to exercise their rights and to perform their respective obligations under the LCH Agreements and each Contract (together, the “**Relevant Contracts**”) and have duly authorised, executed and delivered the LCH Agreements and each such Relevant Contract;
- (f) LCH and each Relevant Clearing Member are in compliance with applicable laws of their respective jurisdictions at all times, including in respect of any applicable licensing, registration, authorisation, and consent requirements necessary for entering into and performing their respective obligations under the LCH Agreements and the Relevant Contracts;
- (g) The LCH Agreements and all amendments thereto have been properly adopted by LCH in accordance with applicable law;
- (h) LCH and each Relevant Clearing Member have entered into each Relevant Contract for *bona fide* commercial purposes and on an arm’s-length basis;
- (i) the obligations assumed between LCH and each Relevant Clearing Member under the LCH Agreements are mutual;

- (j) LCH and each Relevant Clearing Member have entered into a CM Agreement, Deed of Charge and Security Deed, as applicable, on terms identical to the template versions we have reviewed, which have not been subsequently varied or modified;
- (k) there are no other agreements, instruments or arrangements between LCH and any Relevant Clearing Member which conflict with, modify or supersede the LCH Agreements;
- (l) LCH and each Relevant Clearing Member will perform (and not waive) their respective obligations under the LCH Agreements in accordance with their terms;
- (m) in all circumstances, LCH exercises its rights under the LCH Agreements (including the Default Rules) in the event of a Relevant Clearing Member's default;
- (n) at the time that the LCH Agreements and each Relevant Contract are entered into, or any obligation in respect of each comes into existence, neither LCH nor any Relevant Clearing Member is aware (or should be aware) of the commencement of insolvency proceedings in respect of the other;
- (o) LCH is at all relevant times solvent and not subject to insolvency, reorganisation or similar proceedings under the laws of any jurisdiction;
- (p) the Charged Property delivered pursuant to the Deed of Charge constitutes "financial collateral" that is "book-entry securities collateral" (each as defined in the Financial Collateral Arrangements (No 2) Regulations ("FCA Regulations"));
- (q) the Charged Property is held by an "intermediary" (as defined in the FCA Regulations) and the "relevant account" (as defined in the FCA Regulations), the Charged Property and the Charged Assets are located in England & Wales;
- (r) the requirements of the applicable laws governing the transfer of cash and securities are complied with so as to ensure the validity of each such transfer;
- (s) except as otherwise discussed herein, in the event of a default of a Relevant Clearing Member, LCH's access to the Collateral of the Clearing Clients of the Defaulter is not impeded pursuant to the laws and/or regulations of the jurisdiction where such Collateral may be held;
- (t) no Relevant Clearing Member is a European public limited liability company that was converted to a UK Societas in accordance with Regulation 12A of the European Public Limited-Liability Company Regulations 2004;
- (u) no Relevant Clearing Member is subject to ongoing insolvency proceedings as of the date of this Memorandum; and
- (v) no revisions to the LCH Agreements will contradict or change any of the assumptions set out above.

#### 4. LIMITATIONS AND QUALIFICATIONS

This Memorandum is subject to the following limitations and qualifications.

# Katten

- (a) The views expressed in this Memorandum are based solely on the laws and rules discussed herein as in effect on the date hereof and we undertake no obligation to update this Memorandum as of any subsequent date.
- (b) We express no view as to matters of fact or on the commercial purpose, commerciality or profitability of any arrangements analysed herein.
- (c) We express no opinion as to any liability to tax or accounting policy which may arise or be suffered, directly or indirectly, as a result of or in connection with the LCH Agreements or any Relevant Contract.
- (d) We assume no responsibility to advise you of, or to supplement this Memorandum in relation to, any changes with respect to any matters described in this Memorandum that may occur subsequent to the date hereof or that may hereafter otherwise come to our attention, or to address any changes in any laws, regulations or judicial decisions that may hereafter occur.
- (e) We express no view in respect of:
  - (i) any clearing services provided by FCM Clearing Members to FCM Clients pursuant to LCH's FCM Regulations and FCM Procedures; or
  - (ii) any matters arising under LCH's Sponsored Clearing Regulations.
- (f) We express no view in respect of any actions that LCH may attempt to take pursuant to its rights under the LCH Agreements in any other jurisdiction.
- (g) As used herein, the term "**enforceable**" means that the obligations assumed by the relevant party are, in the case of documents governed by English law, of the type which English courts may enforce. This Memorandum is not to be taken to imply that any obligation would necessarily be capable of enforcement in all circumstances in accordance with its terms. In particular:
  - (i) an English court will not necessarily grant a particular remedy because:
    - (A) the principles of equity dictate otherwise, e.g. an order for the equitable remedy of specific performance may not be made where damages are considered to be an adequate remedy;
    - (B) it may be incompatible with the Human Rights Act 1988;
    - (C) public policy requires otherwise; or
    - (D) the court otherwise has discretion as to what remedy it grants;
  - (ii) claims may become barred under the Limitation Act 1980 (as amended) or the Foreign Limitation Periods Act 1984 (as amended including by The Law Applicable to Non-Contractual Obligations (England and Wales and Northern Ireland) Regulations and The Law Applicable to Contractual Obligations (England and Wales and Northern Ireland)), or may be or become subject to a defence of set-off or counterclaim;

- (iii) the enforcement of an obligation may be limited by the provisions of English law which may hold an agreement to have been frustrated by a supervening event; and
  - (iv) the provisions of English law relating to misrepresentation, mistake and fraud may mean that an agreement, or part of it, is rescinded and therefore unenforceable.
- (h) Except where otherwise stated, many of the matters addressed herein are not subject to any reported, final controlling judicial precedent. Therefore, although we believe the views expressed in this Memorandum are supported by sound analysis, it is not a guarantee as to what a particular English court would actually hold.
- (i) If a Relevant Clearing Member is resident or incorporated in a country which is subject to sanctions imposed or recognised by the United Kingdom, then the obligations of that Relevant Clearing Member to LCH under the LCH Agreements may be unenforceable or void. If a person who controls, or is connected with, a party to the LCH Agreements is resident, or incorporated, in a country which is subject to sanctions imposed or recognised by the United Kingdom, then the obligations of the other party to such party under the LCH Agreements may be unenforceable or void.
- (j) Insolvency proceedings with respect to any Relevant Clearing Member will likely proceed under, and be governed by, the insolvency laws in force in this jurisdiction at the time of commencement of the relevant proceedings, and will not benefit from any automatic recognition in EU member states under Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

## 5. ANALYSIS

### 5.1 Membership

#### 5.1.1 Will the rights and obligations of LCH and each Relevant Clearing Member under the LCH Agreements constitute legal, valid, binding and enforceable rights and obligations?

Subject to the assumptions, limitations and qualifications set out above, and to the analysis set out below, it is our view that the rights and contractual obligations of LCH and the Relevant Clearing Members under the LCH Agreements constitute legal, valid, binding, and enforceable rights and contractual obligations under the laws of this jurisdiction.

#### 5.1.2 Are there any statutory limitations on the capacity of, or specific regulatory requirements associated with, any Relevant Clearing Member entering into the LCH Agreements (including for the purpose of granting of security under the Deed of Charge)?

Section 19 of FSMA prohibits any person from carrying on a regulated activity by way of business in the United Kingdom unless such person is either an authorised or exempt person (“**General Prohibition**”).<sup>1</sup> For an activity to be a “regulated activity”, it must be a “specified

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<sup>1</sup> In respect of the “by way of business” criterion, the Financial Conduct Authority (“FCA”) has given detailed guidance as to its requirements for an activity to be conducted by way of business in PERG 2.3. In essence, there is no single

activity” relating to a “specified investment”. The list of specified activities and specified investments – and hence the overall scope of the General Prohibition – is set out in the Financial Services and Markets Act (Regulated Activities) Order 2001 (“**RAO**”).

To the extent that a Relevant Clearing Member carries on, in the United Kingdom, any of the regulated activities set out in the RAO, such Relevant Clearing Member would fall within the scope of the General Prohibition and would need either to obtain FCA authorisation or find an applicable exemption or exclusion. Note that, where a person is undertaking a specified activity in respect of a specified investment, if such activity falls within an exclusion, then the activity does not constitute a regulated activity under FSMA or the RAO and is not subject to the General Prohibition.

Separately, UK law prohibits the making of an invitation or inducement to engage in investment activities (“**financial promotion**”)<sup>2</sup> in the United Kingdom other than in accordance with Section 21 of FSMA and the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 (“**FPO**”) (together, the “**Financial Promotion Prohibition**”). There are several well-known exceptions to the Financial Promotion Prohibition. For example, Section 21(2)(b) of FSMA permits the making of financial promotions to the extent that the content of the communication is approved by an FCA-authorized person.

Failure to abide by either the General Prohibition or the Financial Promotion Prohibition is a criminal offence.<sup>3</sup> In addition, any agreement entered into by a party in contravention of either the General Prohibition or the Financial Promotion Prohibition is unenforceable against the other party (or parties) to that agreement.<sup>4</sup> Accordingly, where a Relevant Clearing Member enters into the LCH Agreements or a Relevant Contract when it should have been FCA authorised but was not, or as a result of making communications that breach the Financial Promotion Prohibition, such Relevant Clearing Member may not be able to enforce the terms of the LCH Agreements or Relevant Contract against LCH.

5.1.3 Would LCH be deemed to be domiciled, resident or carrying on business in the Relevant Jurisdiction by virtue of providing clearing services to a Relevant Clearing Member? If so, would LCH be required to obtain a license or be registered before providing clearing services to a Relevant Clearing Member or are there any special local arrangements for the recognition of overseas clearing houses in these circumstances?

We do not consider the first question to be relevant because LCH is domiciled, resident, and carrying on business in England & Wales.

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test, though whether or not an activity is carried on by way of business is ultimately a question of judgment that takes account of several factors, none of which is likely to be conclusive. These include the degree of continuity, the existence of a commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated. See PERG 2.3.3 G. Given that the Relevant Clearing Members are making use of LCH’s clearing services for a commercial purpose and for compensation, we believe such activities are properly characterised as conducted “by way of business”.

<sup>2</sup> A financial promotion may be made interactively (*e.g.*, in person or by telephone), legibly (*e.g.*, by letter, website or other written material), or generally (*e.g.*, via a broadcast medium).

<sup>3</sup> See Section 23 of FSMA (in respect of the General Prohibition); and Section 25 of FSMA (in respect of the Financial Promotion Prohibition).

<sup>4</sup> See Section 26 of FSMA (in respect of the General Prohibition); and Section 30 of FSMA (in respect of the Financial Promotion Prohibition).



In respect of the second question, as noted in our response to Question 5.1.2, *supra*, the General Prohibition would not normally apply to exempt persons. An “exempt person” includes, *inter alia*, a UK central counterparty in relation to which a recognition order is in force (“RCCP”). The status of RCCP is restricted to UK central counterparties that meet the requirements of EMIR.<sup>5</sup> With effect from 12 June 2014, LCH has been recognised by the Bank of England as an authorised central counterparty under Article 14 of EMIR and is therefore an RCCP and an exempt person under FSMA.<sup>6</sup>

However, the status of exempt person does not act as a total bar to the potential application of the General Prohibition to an RCCP. Article 285(3A) of FSMA clarifies that an RCCP is exempt from the General Prohibition only “as respects any regulated activity which is carried on *for the purposes of, or in connection with*, the services or activities specified in its recognition order” (emphasis added). Therefore, where an exempt person such as an RCCP engages in activities that would otherwise fall within the scope of the RAO, but does so “for the purposes of, or in connection with” its business as an RCCP, the General Prohibition will not apply and the RCCP will not require authorisation.

By contrast, where an RCCP engages in activities that are not “for the purposes of, or in connection with” its business as an RCCP, then the General Prohibition applies in respect of such activities. An exempt person – such as an RCCP – that, for any reason, becomes subject to the General Prohibition may nevertheless qualify for an exclusion from each activity under the RAO for which it is not exempt, in which case no authorisation requirements would apply.

In our view, the clearing services provided by LCH to the Relevant Clearing Members pursuant to the LCH Agreements are clearly “for the purposes of, or in connection with” LCH’s business as an RCCP. Accordingly, for as long as LCH maintains its status as an RCCP, and provides clearing services to the Relevant Clearing Members within the scope of its recognition order, LCH will remain an exempt person, and hence not subject to the General Prohibition, in respect of providing such clearing services.

5.1.4 What type of documents should be obtained by LCH to evidence that a Relevant Clearing Member and its officers have the capacity and authority to enter into the LCH Agreements? Is LCH required to verify such evidence?

Under English law, a contract is only enforceable where the parties have the capacity and authority to enter into it.

### *Capacity*

An English company must generally act in accordance with the objects for which it was formed. Nevertheless, an English company’s objects are presumed to be unrestricted unless any specific

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<sup>5</sup> Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, as it forms part of UK domestic law by virtue of the EUWA, and as amended from time to time in accordance with UK law.

<sup>6</sup> See Section 288(1) of FSMA (requiring that, in order for a UK entity to provide central counterparty services, it must apply to the Bank of England in accordance with EMIR); see also Part 5 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges, Clearing Houses and Central Securities Depositories) Regulations 2001 (requiring that, to be recognised, a central counterparty providing clearing services must meet the requirements of EMIR). Prior to the effective date of EMIR, LCH was classified as a “recognised clearing house” (“RCH”), which was, and remains, another category of exempt person under FSMA.

limitations are contained in its articles of association.<sup>7</sup> Moreover, the validity of any act performed by an English company – including entry into an agreement – may not be challenged on the grounds of a lack of capacity based on anything in its constitution.<sup>8</sup> Therefore, absent any restrictions in its articles, and subject to the two following clarifications, a Relevant Clearing Member will have the power to enter into the LCH Agreements.

An unregistered company – such as Relevant Clearing Member that is a royal charter company – is not subject to the foregoing provisions of the CA 2006, and instead its capacity to enter into an agreement is established by its constitutional documents. In addition, a Relevant Clearing Member that is a Building Society may engage in any activity authorised by its memorandum and rules, subject to certain limitations prescribed by the BSA 1986.<sup>9</sup>

### *Authority*

An English company may be bound by any person acting under its authority, whether that authority is express or implied.<sup>10</sup> Where a person purports to enter into an agreement on behalf of an English company with a counterparty, but no such authority exists, the company could claim that it is not bound by such agreement. Therefore, the counterparty would seem to bear the heavy burden of conclusively establishing that a person purporting to act on behalf of an English company has the authority to do so.

Nevertheless, a counterparty that deals with an English company in good faith is not required to enquire as to any limitation on the powers of the company’s directors to bind the company, or to authorise others to do so.<sup>11</sup> For these purposes, there is a presumption of good faith on behalf of the counterparty, which shifts the burden to the English company to demonstrate both the existence of bad faith and its own lack of authority.<sup>12</sup> As a result, an English company will be bound by an agreement entered into with a counterparty by its directors, or by a person authorised by them to do so, notwithstanding any restrictions in its articles and provided the counterparty is acting in good faith.

### *Documentation*

In light of the foregoing considerations, LCH should undertake an appropriate amount of due diligence before entering into the LCH Agreements with a Relevant Clearing Member. Recommended steps include obtaining a Relevant Clearing Member’s constitutional documents and determining that there are no relevant restrictions on its capacity to enter into the LCH Agreements or, if such restrictions exist, that they have been removed through a valid process of amendment. In addition, LCH should obtain copies of the applicable minutes of the directors meeting(s) at which authorisation of entry into the LCH Agreements took place as well as

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<sup>7</sup> See Section 31(1) of the CA 2006. This presumption applies from 1 October 2009. An objects clause applicable to a company formed prior to that date was deemed to be thenceforward treated as part of the company’s articles, and therefore subject to amendment by the company to remove any restrictions. See Section 28(1) of the CA 2006.

<sup>8</sup> See Section 39(1) of the CA 2006.

<sup>9</sup> See, e.g., Section 5(1) of the BSA 1986 (requiring that a Building Society have as its sole or principal purpose “making loans which are secured on residential property and are funded substantially by its members”). See also Section 9A of the BSA 1986 (restricting Building Societies from transacting in certain classes of financial products).

<sup>10</sup> See Section 43(1)(b) of the CA 2006.

<sup>11</sup> See Section 40 of the CA 2006.

<sup>12</sup> *Id.* at Section 40(2)(b). A counterparty will not be characterised as acting in bad faith solely because it had actual knowledge that the agreement in question exceeded the power of the directors under the company’s constitution. *Id.*

appropriate documentation establishing the authority of the signatories executing the LCH Agreements on behalf of a Relevant Clearing Member.<sup>13</sup> LCH should also obtain a copy of each signatory's specimen signature.

All copies of the foregoing documentation should be appropriately certified and the Relevant Clearing Member should be required to represent that there have been no changes to any such documentation prior to the time the LCH Agreements are executed.<sup>14</sup>

5.1.5 Are there any formalities to be complied with upon entry into of any of the LCH Agreements and, if so, what is the effect of a failure to comply with these? Please consider in particular any formalities to be complied with to enter into the Deed of Charge and Security Deed.

The execution formalities applicable to English companies differ between agreements that are contracts and agreements that are deeds.

### *Contracts*

As noted as noted in our response to Question 5.1.4, *supra*, an agreement may be made on behalf of an English company by any person (including a director) with express or implied authority to do so.<sup>15</sup> Where an English company executes an agreement directly, either voluntarily or as the result of a legal requirement, valid execution requires either the signatures of two "authorised signatories" or the signature of a director of the company in the presence of a witness attesting to the director's signature.<sup>16</sup> "Authorised signatories" for purposes of the first option include each director as well as the secretary of the company.<sup>17</sup>

The signature page of the CM Agreement requires two signatories to sign in the name of the Relevant Clearing Member. Therefore, provided both signatories are "authorised signatories", their signatures will constitute valid execution of the CM Agreement by the Relevant Clearing Member. We are unaware of any requirement under English law for the CM Agreement to be executed personally by the Relevant Clearing Member, in which case LCH could, if it so chose, permit the CM Agreement to be executed on behalf of the Relevant Clearing Member by a person acting under the Relevant Clearing Member's authority pursuant to Section 43(1)(b) of the CA 2006.<sup>18</sup>

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<sup>13</sup> For example, where a signatory is a director, or the secretary, of the Relevant Clearing Member, it will be necessary to obtain the relevant Form AP01 (appointment of a director) or Form AP03 (appointment of a secretary). In addition, where an agreement is executed as a deed, a person who is not a director or secretary must be appointed to execute the deed by a power of attorney. *See* Section 47 of CA 2006.

<sup>14</sup> We note in this regard that clause 2.2 of the CM Agreement requires each Relevant Clearing Member to warrant that all information it has supplied to LCH in connection with its application for admission "was and is at the date of [the CM Agreement] true and accurate in all material respects".

<sup>15</sup> *See* footnote 10 and accompanying text, *supra*.

<sup>16</sup> *See* Section 44(2) of the CA 2006. In the alternative, an English company can execute an agreement by the affixing of its common seal. *Id.* at Section 44(1)(a).

<sup>17</sup> *Id.* at Section 44(3). Where the same individual constitutes two "authorised persons" – for example, because that person is both a director and secretary of the same company – it is unlikely that an agreement could be validly executed by such individual signing twice.

<sup>18</sup> LCH could also permit a Relevant Clearing Member to execute the CM Agreement by affixing its common seal pursuant to Section 44(1)(a) of the CA 2006, although this is less likely to occur in practice.

## *Deeds*

For a deed to be validly executed by an English company, it must be duly executed by the company and delivered by the company.<sup>19</sup> Due execution requires either the signatures of two authorised signatories or the signature of a director in the presence of a witness who attests to the signature.<sup>20</sup> A company may also use a power of attorney to appoint a person to execute a deed on its behalf.<sup>21</sup> The attorney must sign either in the presence of a witness who attests to the signature or at such attorney's direction and in such attorney's presence and the presence of two witnesses both of whom attest to the signature.<sup>22</sup> A deed is delivered by a company upon execution, unless a contrary intention is proved.<sup>23</sup>

The signature page of the Deed of Charge requires two signatories to sign in the name of the Relevant Clearing Member. Therefore, provided both signatories are "authorised signatories", their signatures will constitute valid execution of the Deed of Charge by the Relevant Clearing Member. LCH could, if it so chose, permit the CM Agreement to be executed on behalf of the Relevant Clearing Member by an attorney pursuant to a duly executed power of attorney. In respect of delivery, the Deed of Charge specifies that LCH shall separately indicate the date of delivery and the date of execution. That the Deed of Charge anticipates a possible difference between these two dates could serve to rebut the presumption in favour of immediate delivery. LCH should therefore take care to indicate on the Deed of Charge a date of delivery.

For the sake of completeness, we would note that an English company registered under the CA 2006 is ordinarily required to register certain "charges" with Companies House.<sup>24</sup> Failure to do so within 21 days of the charge's "creation" renders the charge void against any liquidator, administrator or creditor of the company.<sup>25</sup> For these purposes, a "charge" includes a mortgage such as the Deed of Charge.<sup>26</sup> Nevertheless, the registration requirement does not apply in respect of any charges that form part of a "security financial collateral arrangement".<sup>27</sup> For the reasons set out in Section 5.2.2, *infra*, it is our view that the Deed of Charge forms part of a security financial collateral arrangement, and therefore the Deed of Charge will not be void for failure to register under the CA 2006.

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<sup>19</sup> See Section 46(1)(a)-(b) of the CA 2006.

<sup>20</sup> See footnote 16, *supra*, and accompanying text.

<sup>21</sup> See Section 47 of the CA 2006. The power of attorney must itself be validly executed as a deed. *Id.*

<sup>22</sup> See Section 1(3)(a) of the Law of Property (Miscellaneous Provisions) Act 1989.

<sup>23</sup> See Section 46(2) of the CA 2006.

<sup>24</sup> *Id.* at Section 859A.

<sup>25</sup> *Id.* at Section 859A(H)(3). The date of a deed's "creation" for these purposes is the date on which the deed is delivered. *Id.* at Section 859E(1).

<sup>26</sup> Under English law, a mortgage generally refers to an arrangement by which a debtor transfers ownership or title to one or more assets to a creditor, with the understanding that the creditor will return the asset(s) upon discharge of the debt. We think it likely that an English court would conclude that the purpose and operation of the Deed of Charge would satisfy these requirements and would be properly characterised as a mortgage.

<sup>27</sup> See Section 859A(6)(c) of the CA 2006.

## *Royal Charter Corporations*

The execution formalities discussed above also generally apply to Relevant Clearing Members that are royal charter corporations.<sup>28</sup> Nevertheless, we would recommend that LCH review the specific circumstances of a Relevant Clearing Member that is a royal charter corporation when determining the relevant execution formalities.

## *Electronic Signatures*

Under English law, the formalities for creating a binding contract do not depend on the means used.<sup>29</sup> Accordingly, it is generally permissible to execute a contract using electronic means, provided the requisite elements for contract formation are present.<sup>30</sup>

Generally speaking, for an “electronic signature” – defined as anything in electronic form which is attached to, or associated with, other electronic data and used by a signatory to sign a document<sup>31</sup> – to be effective, there must be some element of authenticating intent and that any other formalities relating to execution must be met. As discussed above, in the case of a deed executed by a company, such formalities may require the signature of a company director in the presence of a witness that attests to the signature.<sup>32</sup> In such circumstances, provided the witness and the signatory are physically present in the same location, they may use electronic means to validly execute the deed.<sup>33</sup>

### 5.1.6 Would the courts of the Relevant Jurisdiction uphold the contractual choice of law and jurisdiction set out in Regulation 51?

Regulation 51(a) establishes that the Regulations and the Relevant Contracts, including all non-contractual or other obligations arising out of or in connection therewith, “shall be governed by and construed in accordance with English law”. Subject to the following discussion, we believe that an English court would give effect to this choice of law.

## *Governing Law – Contractual Obligations*

An English court will determine the validity and enforceability of a governing law clause in a contract in accordance with legislation known as Rome I.<sup>34</sup> The foundational principle of the

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<sup>28</sup> See paragraph 3 of Schedule 1 to the Unregistered Companies Regulations 2009, SI 2436/2009 (“UCRs”) (applying Sections 43, 44, 45(1) and 46 to unregistered companies, a term which includes royal charter corporations). Please note that the UCRs do not apply Section 859A to unregistered companies, meaning that the requirements in relation to registering the Deed of Charge with Companies House discussed above are not relevant to royal charter corporations.

<sup>29</sup> For example, absent a statutory requirement to the contrary, a contract need not be in writing nor signed to be effective under English law.

<sup>30</sup> See “Statement of the Law: Execution with an Electronic Signature” in Law Commission, *Report on Electronic Execution of Documents* (2019).

<sup>31</sup> See, e.g., Section 7(2) of the Electronic Communications Act 2000.

<sup>32</sup> See footnote 16, *supra*, and accompanying text.

<sup>33</sup> For a discussion of the requirement for physical presence in the same location in relation to execution of a deed, see The Law Society: Our position on the use of virtual execution and e-signature during the coronavirus (COVID-19) pandemic (6 January 2021).

<sup>34</sup> See Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) (“EU Rome I”). The UK subsequently converted EU Rome I into UK domestic law in anticipation of the UK’s departure from the EU. See Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) (Retained EU law) (“UK Rome I”). In the UK, EU Rome I continues to apply in respect of contracts made from 17 December 2009 and before 31 December 2020,

Rome I framework is to provide maximum freedom for contracting parties to select the governing law of their agreement.<sup>35</sup> Therefore, the express choice of English law in Regulation 51(a) will be recognised by an English court unless an exemption applies to modify the choice of law.

These exemptions generally apply where wholly domestic parties choose a foreign governing law where the foreign jurisdiction has only a limited nexus to the subject matter of the agreement.<sup>36</sup> For purposes of this analysis, LCH and the Relevant Clearing Members have chosen English law, are physically located in this jurisdiction, and this is the jurisdiction in which all (or nearly all) obligations under the LCH Agreements and the Relevant Contracts will occur. Accordingly, we do not believe any of these exemptions are likely to apply.

Finally, there is an exemption that applies where a parties' choice of law is "manifestly incompatible" with the public policy of the forum.<sup>37</sup> We are unaware of any legal authority that would support the conclusion that an English court would find the choice of English law to be "manifestly incompatible" with local public policy and, accordingly, we do not believe this exemption would apply to interfere with the choice of English law in Regulation 51(a).

### *Governing Law – Non-Contractual Obligations*

An English court will determine the governing law applicable to non-contractual obligations in accordance with legislation known as Rome II.<sup>38</sup> As is the case under Rome I, the Rome II framework grants parties wide freedom to select the law applicable to non-contractual obligations.<sup>39</sup> The only condition is that the choice of law be "expressed or demonstrated with reasonable certainty", which we believe is met by the wording of Regulation 51(a). There are a series of exemptions that modify the parties' choice of law, however they generally concern domestic parties choosing a foreign governing law, which is not applicable here.<sup>40</sup>

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whereas UK Rome I applies in respect of contracts made thereafter. For purposes of this analysis, there are no material divergences between EU Rome I and UK Rome I, and accordingly we only refer to "Rome I" in the remainder of this discussion.

<sup>35</sup> See Article 3(1) of Rome I ("A contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable of the whole or to part only of the contract".)

<sup>36</sup> See, e.g., Article 3(3) (mandatory rules of local law will override the choice of foreign governing law), Article 9(2) (mandatory rules of law of the court determining the claim will override the choice of law), and Article 9(3) (mandatory rules of law of the place of performance will override the choice of law to the extent they render the contract unlawful). In addition, Article 12(2) of Rome I provides that, in relation to the manner of performance and the steps to be taken in the event such performance is defective, "regard shall be had to the law of the country in which performance takes place".

<sup>37</sup> See Article 21 of Rome I.

<sup>38</sup> See Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) ("EU Rome II"). The UK subsequently converted EU Rome II into UK domestic law in anticipation of the UK's departure from the EU. See Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) (Retained EU law) ("UK Rome II"). In the UK, EU Rome II applies to events giving rise to damage occurring prior to 31 December 2020, whereas UK Rome II applies to events occurring subsequently. For purposes of this analysis, there are no material divergences between EU Rome II and UK Rome II, and accordingly we only refer to "Rome II" in the remainder of this discussion.

<sup>39</sup> See Article 14(1) of Rome II ("The parties may agree to submit non-contractual obligations to the law of their choice...").

<sup>40</sup> See, e.g., Article 14(2) (mandatory rules of local law will override the choice of foreign governing law) and Article 16 (mandatory rules of law of the court determining the claim will override the choice of law).

Rome II also contains a “public policy” exemption similar to Rome I.<sup>41</sup> For the reasons set out in our analysis above regarding Rome I, we see no basis for the application of the public policy exemption by an English court to refuse a choice of English governing law. Accordingly, we believe an English court would generally uphold the parties’ choice of English law to govern non-contractual obligations.

## *Arbitration*

We note that Regulation 51(b) provides that disputes between LCH and a Relevant Clearing Member shall be referred to arbitration. Arbitration proceedings in this jurisdiction are subject to the Arbitration Act 1996 (“**AA 1996**”). The parties are generally permitted wide flexibility to determine the rules and procedures applicable to resolving disputes, failing which the discretion to make such determinations falls to the tribunal itself.<sup>42</sup>

We note in this regard that the Rulebook makes reference to the LCIA Arbitration Rules of The London Court of International Arbitration (“**LCIA Rules**”).<sup>43</sup> In this regard, we note that the LCIA Rules will respect the choice of law made by the parties in writing, provided that such choice is not prohibited by “the law of the arbitral seat”.<sup>44</sup>

For the reasons set out above, we believe that the laws of this jurisdiction would recognise the parties’ choice of English law to govern the Rulebook and the Relevant Contracts, and the agreement on the choice of law is made in writing. Accordingly, we believe that a duly constituted arbitral tribunal applying the LCIA Rules would reach the same conclusion.

## *Jurisdiction*

Regulation 51(c) establishes that any disputes arising from or in relation to the Regulations and to Relevant Contracts that are not referred to arbitration are subject to the exclusive jurisdiction of the English courts. When determining the validity and enforceability of an exclusive jurisdiction clause designating the courts of England & Wales, an English court will apply the terms of the 2005 Hague Convention on Choice of Court Agreements (“**Hague Convention**”).<sup>45</sup>

The Hague Convention applies as between the relevant contracting states (the UK, EU, Mexico, Singapore, Montenegro) where an agreement designates that the courts of one such state have exclusive jurisdiction. To qualify, the agreement must be made in writing (or otherwise accessible for future reference) between multiple parties for purposes of deciding disputes in connection with a particular legal relationship.<sup>46</sup> Regulation 51(c) is a written agreement

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<sup>41</sup> *Id.* at Article 26.

<sup>42</sup> *See, e.g.*, Section 34 of the AA 1996.

<sup>43</sup> This reference only appears in the definitions section of the Rulebook. However, it is our understanding that LCH and the Relevant Clearing Members intend that any disputes arising between them are resolved in accordance with the LCIA Rules.

<sup>44</sup> *See* Rule 16.4 of the LCIA Rules.

<sup>45</sup> *See* Civil Jurisdiction and Judgments (Hague Convention on Choice of Court Agreements 2005) Regulations, SI 2015/1644. The UK joined the Hague Convention as a contracting party in its own right on 1 January 2021. The EU framework for determining jurisdiction – including the Recast Brussels Regulation, the 2001 Brussels Regulation and the 2007 Lugano Convention – does not apply to proceedings instituted in the UK on or after 1 January 2021. The UK has applied to join the 2007 Lugano Convention however, as of the date of this Memorandum, it has not received the necessary consents from the other contracting parties.

<sup>46</sup> *See* Article 3 of the Hague Convention.

between LCH and a Relevant Clearing Member that confers exclusive jurisdiction on the courts of England & Wales, and therefore falls within the scope of the Hague Convention.

Under the Hague Convention, an exclusive jurisdiction clause designating the courts of one of the contracting states shall be given effect unless the agreement in question is null and void under the law of that state.<sup>47</sup> The designated court may not decline to exercise jurisdiction on the basis that the dispute should be decided by the courts of another jurisdiction.<sup>48</sup> On that basis, an English court would have no authority to refuse to enforce the exclusive jurisdiction of the courts of England & Wales to hear disputes as provided for in Regulation 51(c).

5.1.7 Will the courts uphold the judgment of the English courts or an English arbitration award?

We do not consider the first question to be relevant because there is no foreign judgement to be upheld by the English courts.

An English court will enforce an English arbitration award as provided for in the AA 1996. An agreement to arbitrate is valid under the AA 1996 so long as it is made in writing and there is sufficient evidence that the parties did, in fact, intend to agree to submit to arbitration.<sup>49</sup> In our view, the unambiguous language in Regulation 51(b) meets this standard and is therefore valid under the AA 1996.

Any award made by an arbitration tribunal may be enforced, by leave of an English court, in the same manner as a judgment or order from that court to the same effect.<sup>50</sup> A party may appeal against an arbitral award on several grounds.<sup>51</sup> Provided that no such grounds exist, we would expect an English court to enforce an arbitration award rendered pursuant to Regulation 51(b).

5.1.8 Are there any “public policy” considerations that the courts of the Relevant Jurisdiction may take into account in determining matters related to choice of law and/or the enforcement of foreign judgments?

The relevant public policy considerations are set out in the response to Question 5.1.6, *supra*.

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<sup>47</sup> *Id.* at Article 5(1).

<sup>48</sup> *Id.* at Article 5(2).

<sup>49</sup> *See* Section 5 of the AA 1996.

<sup>50</sup> *Id.* at Section 66(1). Leave to enforce may be refused where the person against whom enforcement is sought shows that the arbitral tribunal lacked jurisdiction to make the award.

<sup>51</sup> *See* Section 71 of the AA 1996 (providing that such challenges may be raised on the basis: (i) that the tribunal lacks substantive jurisdiction; (ii) that the proceedings were improperly conducted; (iii) that there has been a failure to comply with the arbitration agreement or the provisions of the AA 1996; and (iv) that there has been any other irregularity affecting the tribunal or the proceedings).



## 5.2 Insolvency, Security, Set-Off and Netting

### 5.2.1 Please identify the different types of Insolvency Proceedings and Reorganisation Measures. Would any of these not be covered by those events entitling LCH to liquidate, transfer or otherwise deal with Contracts as provided for in Rule 5 of the Default Rules? Are any other events or procedures not envisaged in Rule 5 of the Default Rules relevant?

If a Relevant Clearing Member that is an English company becomes unable to pay its debts, or is likely to become so, such Relevant Clearing Member may be subject to winding-up (liquidation) or administration as provided for in the Insolvency Act 1986 (“**Insolvency Act**”) and the Insolvency (England and Wales) Rules 2016 (“**Insolvency Rules**”).<sup>52</sup> In addition, a Relevant Clearing Member that is an English company may propose a company voluntary arrangement (“**CVA**”) under the Insolvency Act or a scheme of arrangement or restructuring plan under the CA 2006. In limited circumstances, administrative receivership under the Insolvency Act may apply.

Specialised insolvency and administration proceedings under the BA 2009 may apply to certain Relevant Clearing Members. Specifically, certain UK banks may be subject to bank insolvency or bank administration, certain UK investment banks may be subject to investment bank special administration, and UK Building Societies may be subject to building society insolvency or building society special administration. In addition, certain UK banks and UK Building Societies may also be subject to the exercise of so-called “stabilisation powers” under the Special Resolution Regime (“**SRR**”) of the BA 2009.

Finally, a Relevant Clearing Member that is a royal charter corporation is generally wound up by the revocation of its charter. A Relevant Clearing Member that is a UK Branch may be subject to winding-up or a scheme of arrangement or restructuring plan. In certain circumstances, a UK Branch may also be subject to a CVA or administration.<sup>53</sup>

The foregoing constitute the “**Insolvency Proceedings**” under the laws of this jurisdiction, which in our view cover the events specified in Rule 5 of the Default Rules. Each is discussed in greater detail below.

We would note that the new statutory moratorium under the Insolvency Act, introduced pursuant to the Corporate Insolvency and Governance Act 2020 (“**CIGA**”), is not one of the events specified in Rule 5 of the Default Rules. However, we do not believe this new moratorium is likely to be available to a Relevant Clearing Member because any company that has permission under Part 4A of FSMA to accept deposits, or that is an investment bank or an investment firm, is ineligible to obtain the moratorium.

#### *Winding-Up / Liquidation*

Winding up under the Insolvency Act would occur either by a voluntary resolution of the Relevant Clearing Member’s members and creditors or by a compulsory petition by a creditor

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<sup>52</sup> Note that, as provided below, certain proceedings in respect of a Relevant Clearing Member continue to apply the Insolvency Rules 1986.

<sup>53</sup> A Relevant Clearing Member that is the UK Branch of an credit institution incorporated in a member state of the European Economic Area (“**EEA**”) may be subject to a CVA or administration, whereas a Relevant Clearing Member that is the UK Branch of a non-EEA credit institution is only subject to a CVA or administration where the non-EEA credit institution has its “centre of main interests” in an EEA member state other than Denmark or in the United Kingdom.

or other authorised person.<sup>54</sup> The effect of liquidation is to characterise the insolvent company as a trustee of its own assets to be distributed to creditors in accordance with the statutory scheme prescribed by the Insolvency Act.<sup>55</sup> For that purpose, the company's board is displaced as authorised agent of the company by a liquidator.<sup>56</sup> Following the end of the liquidation, the company is dissolved.

The liquidator has statutory powers to act in relation to the company and statutory rights to challenge transactions entered into prior to liquidation. Such powers and rights include:

- the right to seek restitution of a disposition of company assets made after the commencement of a winding-up, which proceeding is deemed to commence upon the presentation of a winding up petition;<sup>57</sup>
- the power to disclaim onerous contracts;<sup>58</sup> and
- the right to have set aside and to require restitution in respect of a transaction at an undervalue,<sup>59</sup> a preference to a creditor,<sup>60</sup> or a transaction in fraud of the creditors of the corporation,<sup>61</sup> in each case in respect of transactions agreed or executed prior to the liquidation.

In addition, absent a safe harbour, Insolvency Rule 14.25 requires that an account be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other (“**Statutory Insolvency Set-Off**”). The operation of Statutory Insolvency Set-Off is self-executing and automatically sets off all amounts due and owing between a given creditor and a company in liquidation and to recover any amounts due. It is not possible to contract out of Statutory Insolvency Set-Off.

In addition to the statutory rights and powers described above, English courts have recognised two principal doctrines of insolvency law pursuant to which transactions with or in relation to the debtor may be challenged. The “anti-deprivation principle” permits the debtor to avoid any transaction or agreement which, by its terms, is intended to deprive, and aimed at depriving, a company of an asset upon the occurrence of insolvency proceedings.<sup>62</sup> Separately, the “*pari passu* principle” permits a debtor to avoid any transaction or agreement the effect of which is

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<sup>54</sup> See Section 124 of the Insolvency Act.

<sup>55</sup> *Ayerst (HM Inspector of Taxes) v C & K (Construction) Ltd* [1976] A.C. 167.

<sup>56</sup> *Conway v Petronius Clothing Co Ltd* [1978] 1 WLR 72.

<sup>57</sup> See Sections 127 and 129 of the Insolvency Act. Section 127 avoids the disposition of company assets. The right to restitution is a response to that avoidance at common law and in equity. The company might have other rights to restitution in respect of disposition of corporate assets, for example arising from a breach of duty by its directors. Such rights are not rights under the law of insolvency and so are not considered in this Memorandum, which focuses on the legislative measures to protect against the effects of insolvency and does not consider all possible means of challenge to a transaction with an insolvent company.

<sup>58</sup> *Id.* at Section 178.

<sup>59</sup> *Id.* at Section 238.

<sup>60</sup> *Id.* at Section 239.

<sup>61</sup> See Section 423 of the Insolvency Act.

<sup>62</sup> *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383.

to produce a distribution of the assets of the company different from the distribution intended by the statutory scheme.<sup>63</sup>

## *Administration*

A Relevant Clearing Member may also be placed into administration under Schedule B1 to the Insolvency Act, by either an application to an English court or an out of court appointment by the Relevant Clearing Member's board of directors, which appointment is then filed with an English court.<sup>64</sup> The purpose of administration is either to rescue the company as a going concern, to achieve a better result for the company's creditors than would likely be the case if the company were wound up, or to realise the company's assets to satisfy the claims of one or more secured or preferential creditors.<sup>65</sup>

A key feature of an administration is a statutory moratorium on creditors taking action against the company or its assets while the administration is ongoing, absent consent by the administrator or a court order, however this prohibition does not apply to certain arrangements considered in more detail in Section 5.2.2 and 5.2.3, *infra*. The moratorium prohibits any attempt to commence an alternative set of insolvency proceedings.

An administrator has the same powers and rights as those of a liquidator set out above except that an administrator has no power to disclaim onerous contracts and no right to restitution in respect of dispositions of company assets made after the commencement of the administration. Statutory Insolvency Set-Off also applies in an administration.<sup>66</sup>

In addition, the anti-deprivation principle and the *pari passu* principle apply in administration as much as in liquidation, although the latter applies in administration from the date of issue of a notice to distribution only.<sup>67</sup> Without such notice an administration is not a distributive proceeding and there is no basis for the application of the *pari passu* principle.

## *Bank Insolvency*

The bank insolvency regime was introduced as a special procedure for the winding-up of certain "banks".<sup>68</sup> For purposes of this Memorandum, the term "bank" refers to a Relevant Clearing Member that: (i) is an English company; (ii) is authorised under Part 4A of FSMA to accept deposits; and (iii) has depositors eligible for compensation under the Financial Services Compensation Scheme ("FSCS").<sup>69</sup> The purpose of a bank liquidation proceeding is to ensure

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<sup>63</sup> *Id.* The *pari passu* principle does not avoid subordination agreements under which a creditor, in effect, gifts its entitlement to other creditors. See *Re Maxwell Communications Corp plc (No 2)* [1994] 1 BCLC 1; *Re SSSL Realisations (2002) Ltd (in liquidation)* [2005] 1 BCLC 1. It does however avoid an agreement which would seek to benefit a creditor or a set of creditor at the expense of other creditors by agreeing with the corporation or another person a different distribution than that contemplated by the Insolvency Act.

<sup>64</sup> A winding-up/liquidation procedure may follow the completion of an administration procedure.

<sup>65</sup> See paras. 3(1)(a)-(c) of Schedule B1 to the Insolvency Act.

<sup>66</sup> Please note that the legislative basis of Statutory Insolvency Set-Off in an administration is Insolvency Rule 14.24.

<sup>67</sup> *Revenue and Customs Commissioners v Football League Ltd* [2013] 1 BCLC 285.

<sup>68</sup> See Part 2 of the BA 2009.

<sup>69</sup> See Section 91(1) of the BA 2009. Certain institutions, such as credit unions and insurers that accept deposits, are excluded from this regime. See Section 91(2)(b) of the BA 2009 and Banking Act 2009 (Exclusion of Insurers) Order 2010 SI 2010/35.

that eligible depositors are either promptly compensated under the FSCS or transferred to a solvent institution.

A court order appointing a bank liquidator is the only means of starting a bank liquidation.<sup>70</sup> An application for such an order may only be made by the Bank of England (“**BoE**”), the Prudential Regulation Authority (“**PRA**”) or the Secretary of State where certain grounds and conditions are met.<sup>71</sup> The relevant details of the bank liquidation process are set out in the Bank Insolvency (England and Wales) Rules 2009 (SI 2009/356) (“**Bank Insolvency Rules**”), which generally follow the process in the Insolvency Rules, except as needed to give effect to the rapid compensation of eligible depositors.<sup>72</sup> In particular, Statutory Insolvency Set-Off is preserved as are the various powers granted to a liquidator to avoid certain transactions set out above.<sup>73</sup>

### *Bank Administration*

A Relevant Clearing Member that is a bank may also be subject to bank administration.<sup>74</sup> Bank administration is intended to be used alongside the various pre-insolvency stabilisation options under the BA 2009, which generally contemplate the transfer of a failing bank’s business to a third party.<sup>75</sup> A bank administration is intended to ensure that the part of the failing bank that is not transferred (“**residual bank**”) is able to continue providing certain essential systems and services to ensure the third party acquirer can operate the transferred portions of the business effectively.

A bank administration may only be commenced by court order.<sup>76</sup> Applications for such orders may only be made by the BoE where certain grounds and conditions are met, including that the BoE intends to exercise its stabilisation powers under the BA 2009 to make a property transfer.<sup>77</sup> The relevant details of the bank administration process are set out in the Bank Administration (England and Wales) Rules 2009 (SI 2009/357) (“**Bank Administration Rules**”), which generally follow the process in the Insolvency Rules, except as needed to give effect to the purpose of bank administration.<sup>78</sup> Once the bank administration has achieved its

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<sup>70</sup> It remains possible for a bank otherwise eligible for liquidation under the bank insolvency regime to be wound up instead under the standard liquidation proceedings under the Insolvency Act and Insolvency Rules.

<sup>71</sup> See, e.g., Section 7 of the BA 2009 (setting out the conditions that must be met in connection with an application for an order); Section 95(1) of the BA 2009 (limiting applications for an order to BoE, the PRA and the Secretary of State); and Section 96 of the BA 2009 (setting out the grounds on which an application may be made).

<sup>72</sup> Note that the Bank Insolvency Rules are modelled on the Insolvency Rules 1986.

<sup>73</sup> See Rule 72 of the Bank Insolvency Rules (maintenance of Statutory Insolvency Set-Off) and Section 103 of the BA 2009 (applying Section 178 of the Insolvency Act to bank liquidations). There are some notable differences between ordinary liquidation and bank liquidation – for example, the establishment of a liquidation committee and certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>74</sup> See Part 3 of the BA 2009. Note that, for these purposes, the bank may, but is not required to, have eligible depositors as was the case for a bank liquidation.

<sup>75</sup> *Id.* at Section 136(2).

<sup>76</sup> It remains possible for a bank otherwise eligible for administration under the bank administration regime to be subject instead to standard administration proceedings under Schedule B1 to the Insolvency Act and the Insolvency Rules.

<sup>77</sup> See Sections 142-143 of the BA 2009. PRA consent to the appointment of a bank administrator is also required. See Section 362A of FSMA.

<sup>78</sup> There are some notable differences between the Bank Administration process and the administration process under Schedule B1 to the Insolvency Act applicable to non-bank companies – for example, certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

goal of facilitating the transfer of the failing bank's business to the acquiring third party, then the standard administration procedures will apply to the remainder of the process.

## *Building Society Insolvency*

The building society insolvency regime generally follows the bank insolvency regime, subject to certain alterations to reflect the differences between banks and building societies.<sup>79</sup> The purpose of a building society liquidation proceeding is the same as for a bank liquidation: to ensure that eligible depositors are promptly compensated under the FSCS or transferred to a solvent institution.

A court order appointing a building society liquidator is the only means of commencing a building society liquidation.<sup>80</sup> Applications for such orders may only be made by the BoE or the PRA where certain grounds and conditions are met.<sup>81</sup> The relevant details of the building society liquidation process are set out in the Building Society Insolvency (England and Wales) Rules 2010 (SI 2010/2581) ("**BS Insolvency Rules**"), which generally follow the process in the Insolvency Rules, except as needed to give effect to the rapid compensation of eligible depositors.<sup>82</sup> In particular, Statutory Insolvency Set-Off is preserved as are the various powers granted to a liquidator to avoid certain transactions set out above.<sup>83</sup>

## *Building Society Administration*

The building society administration regime generally follows the bank administration regime, subject to certain alterations to reflect the differences between banks and building societies set out in the BS Order. The purpose of a building society administration proceeding is the same as for a bank administration: the continued provision of certain essential systems and services to ensure the third party acquirer can operate the transferred portions of the business effectively.

As in the case of a bank administration, only the BoE has the authority to apply for a building society administration order.<sup>84</sup> Applications for such orders may only be made by the BoE where certain grounds and conditions are met.<sup>85</sup> The relevant details of the building society administration process are set out in the Building Society Special Administration (England and Wales) Rules 2010 (SI 2010/2580) ("**BS Administration Rules**"), which generally follow the process in the Insolvency Rules, except as needed to give effect to the purpose of building

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<sup>79</sup> See Building Societies (Insolvency and Special Administration) Order 2009, SI 2009/805 ("**BS Order**") (applying Part 2 of the BA 2009 to building societies).

<sup>80</sup> See Section 142 of the BA 2009, as modified by the BS Order. It remains possible for a building society otherwise eligible for liquidation under the building society insolvency regime to be wound up instead under the standard liquidation proceedings under the Insolvency Act and Insolvency Rules.

<sup>81</sup> See, e.g., Sections 7, 95(1) and 96 of the BA 2009, as modified by the BS Order.

<sup>82</sup> Note that the BS Insolvency Rules are modelled on the Insolvency Rules 1986. There are some notable differences between ordinary liquidation and building society liquidation – for example, the establishment of a liquidation committee and certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>83</sup> See Rule 73 of the BS Insolvency Rules (maintenance of Statutory Insolvency Set-Off) and Section 2 of the BS Order (applying Part 2 of the BA 2009, including Section 103, to building society liquidations).

<sup>84</sup> It remains possible for a building society otherwise eligible for administration under the building society administration regime to be subject to standard administration proceedings under Schedule B1 to the Insolvency Act and the Insolvency Rules.

<sup>85</sup> See Section 143 of the BA 2009, as modified by the BS Order. PRA consent is also required under Section 362A of FSMA.

society administration.<sup>86</sup> Once the building society administration has achieved its goal of facilitating the transfer of the failing building society’s business to the acquiring third party, then the administration shall continue in a similar way to the standard administration procedures under Schedule B1 to the Insolvency Act.

### *Investment Bank Special Administration*

A Relevant Clearing Member that is an investment bank may also be subject to investment bank special administration.<sup>87</sup> For purposes of this Memorandum, the term “investment bank” refers to a Relevant Clearing Member that: (i) is an English company; (ii) is authorised under Part 4A of FSMA to carry on the regulated activity of safeguarding and administering investments, dealing in investments as agent, or dealing in investments as principal; and (iii) holds client assets.<sup>88</sup> The purpose of investment bank special administration is intended to ensure the return of client assets of a failing investment bank or, where possible, retaining such assets if the investment bank can be rescued.

An investment bank special administration may only be commenced by court order, and various different persons may make an application for such an order.<sup>89</sup> Applications may only be made where certain grounds are met.<sup>90</sup> The relevant details of the investment bank special administration process are set out in the IB Regulations and the Investment Bank Special Administration (England and Wales) Rules 2011 (SI 2011/1301) (“**IB Rules**”). This framework generally adopts the approach for bank and building society administration to follow the standard administration process under Schedule B1 to the Insolvency Act to the extent possible.<sup>91</sup> Note in particular that the powers of an insolvency practitioner to avoid certain transactions as well as Statutory Insolvency Set-Off are preserved for investment bank special administrations.<sup>92</sup>

### *Special Resolution Regime (BA 2009)*

The SRR under the BA 2009 provides for certain powers exercisable by HM Treasury (“**HMT**”), the BoE or the PRA in respect of a certain financial institutions that are failing, or are likely to, fail.<sup>93</sup> As relevant here, the SRR applies to a Relevant Clearing Member that is a

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<sup>86</sup> There are some notable differences between the BS Administration Rules and Schedule B1 of the Insolvency Act – for example, certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>87</sup> See Part 7 of the BA 2009 and the Investment Bank Special Administration Regulations 2011, SI 2011/245 (“**IB Regulations**”).

<sup>88</sup> See Section 232 of the BA 2009. The second element of this definition also includes the regulated activities of managing, or acting as trustee or depository of, an alternative investment fund or a UCITS. See The Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017, SI 2017/443.

<sup>89</sup> These include: the investment bank itself; the investment bank’s directors; one or more creditors of the investment bank; the FCA; or the PRA if the investment bank is PRA-authorised. See Regulation 5(1) of the IB Regulations.

<sup>90</sup> *Id.* at Regulation 6. Consent by the relevant regulator (the FCA or the PRA) to the appointment of an investment bank special administrator is also required. *Id.* at Regulation 8.

<sup>91</sup> There are some notable differences between the investment bank special administration rule framework and Schedule B1 of the Insolvency Act – for example, certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum. In addition, an investment bank special administrator has certain powers to set bar dates to facilitate the prompt return of client assets, which is not available in bank or building society administration proceedings. See Regulations 11 and 12A of the IB Regulations.

<sup>92</sup> See Rule 164 of the IB Rules (preservation of Statutory Insolvency Set-Off) and Regulation 15 of the IB Regulations (application of Section 238, 239, 244, and 423 of the Insolvency Act to investment bank special administrations).

<sup>93</sup> For a description of the preconditions that must be met for triggering the SRR, see Section 7 of the BA 2009.

UK Bank, a UK Building Society or a UK Investment Firm that is failing, or is likely, to fail (each, an “**SRR Entity**”). The exercise of these powers could, absent an exception, impair the rights of creditors, including LCH, in respect of the SRR Entity.<sup>94</sup>

## *CIGA Moratorium*

CIGA introduced a new statutory moratorium under Part A1 of the Insolvency Act. The moratorium, where available, lasts for an initial 20-day period during which management remains in control of the company but where an insolvency practitioner serves as “monitor” to determine whether the company is likely to be rescued. The moratorium may be extended by a further 20-day period without creditor consent, and any further extensions require creditor consent or a court order.

During the moratorium, unless an exception applies, no receiver, liquidator or administrator may be appointed in respect of the company, nor may any person enforce any security or take any action that would cause a floating charge to crystallise as a fixed charge. Pre-moratorium debts become subject to a payment holiday. The payment holiday does not, however, apply in respect of obligations secured or otherwise covered by financial collateral arrangements protected by the FCA Regulations, collateral security charges protected by the SF Regulations or market charges protected by Part VII, each of which are discussed in greater detail in Section 5.2.3, *infra*. As noted above, it is unlikely that any Relevant Clearing Member would be eligible to obtain a moratorium as the categories of ineligible companies include any company that has permission under Part 4A of FSMA to accept deposits, or that is an investment bank or an investment firm.<sup>95</sup>

## *Company Voluntary Arrangement*

A company voluntary arrangement (“**CVA**”) is available to a Relevant Clearing Member that is an English company, that is incorporated in an EEA member state or has its centre of main interest in an EEA member state (other than Denmark) or in the United Kingdom.<sup>96</sup> The process is intended to facilitate a compromise or other arrangement between a company and its creditors, usually a restructuring of debt, with a view to avoiding insolvency proceedings.<sup>97</sup>

Where the company in question is solvent, its directors may propose a CVA to its shareholders and creditors, otherwise responsibility for any proposal falls to the insolvency practitioner.<sup>98</sup> The creditors and shareholders then decide whether or not to approve the proposal, with or without amendments. Where a CVA is approved, it is binding on all creditors who were entitled to vote, or who would have been so had they had notice of the process, in effect binding both known and unknown creditors.<sup>99</sup>

The CVA process does not benefit from any specific moratorium and therefore does not prevent any individual creditors from taking action against the company prior to the approval of the

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<sup>94</sup> For a more detailed discussion of these powers, and available exemptions, *see* Section 5.2.3 of this Memorandum, *infra*.

<sup>95</sup> *See* Schedule ZA1 to the Insolvency Act.

<sup>96</sup> *See* Section 1(4) of the Insolvency Act.

<sup>97</sup> *See* Part 1 of the Insolvency Act.

<sup>98</sup> *See* Sections 1(1), (3) of the Insolvency Act.

<sup>99</sup> *Id.* at Section 5(2)(b).

CVA. Accordingly, the exercise of any rights by a creditor prior to the approval of a CVA will not affect the enforceability of such rights.

### *Scheme of Arrangement*

A scheme of arrangement is conceptually similar to a CVA however it is a statutory process that requires court approval.<sup>100</sup> It is also more widely available than a CVA and could be used by a Relevant Clearing Member that is a foreign company or a royal charter corporation. Once the court order has taken effect, it binds all members and creditors of each class that has approved the scheme.

As under the CVA process, a scheme of arrangement does not prevent any individual creditors from taking action against the company prior to the approval of the scheme by the court. Accordingly, the exercise of any rights by a creditor prior to such approval will not affect the enforceability of such rights.

### *Restructuring Plan*

CIGA introduced a new process, which is similar to a scheme of arrangement but is only available to companies that have encountered or are likely to encounter financial difficulties likely to affect their ability to carry on business as a going concern.<sup>101</sup> One notable difference between the two processes is that a restructuring plan process benefits from a “cross-class cram down” provision which allows the court to sanction a plan as binding, even if one of more class of creditors or members do not approve it, provided that certain conditions are met.

Section 901B of the CA 2006 makes provision for regulations to be made excluding companies providing financial services from the scope of the restructuring plan provisions. In addition, where the company proposing the restructuring plan has utilised the new CIGA moratorium, the court may not sanction a plan if it includes any provision in respect of, *inter alia*, a creditor in respect of any pre-moratorium debt that arises under a contract or other instrument involving financial services which fell due before or during the moratorium (other than by reason of the operation of, or the exercise of rights under, an acceleration or early termination clause in such a contract or other instrument), if that creditor has not agreed to it.<sup>102</sup>

### *Administrative Receivership*

Administrative receivership is a procedure applicable to a Relevant Clearing Member that is an English company registered under the CA 2006.<sup>103</sup> It is process by which certain secured creditors of a company, called “qualifying floating charge holders”, are able to appoint an administrative receiver to manage and sell the company’s assets to satisfy the debt owed.

The use of administrative receivership is generally prohibited, although certain narrow exceptions are permitted including in respect of certain floating charge holders in relation to a clearing or settlement system.<sup>104</sup> Where administrative receivership applies, it does not prevent

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<sup>100</sup> See Sections 895-899 of the CA 2006.

<sup>101</sup> See Sections 901A – 901L of the CA 2006.

<sup>102</sup> *Id.* at Section 901H(5).

<sup>103</sup> See Section 28(1) of the Insolvency Act.

<sup>104</sup> See Section 72A of the Insolvency Act (general prohibition on administrative receivership). See also Sections 72B-H of the Insolvency Act (various exceptions to the general prohibition).



any other creditor from taking enforcement action against the company nor does it benefit from any form of statutory moratorium.

5.2.2 Would the Deed of Charge be effective in the context of Insolvency Proceedings or Reorganisation Measures in respect of a Relevant Clearing Member? Is there anything that would prevent LCH from enforcing its rights under the Deed of Charge? Would LCH be required to take any particular steps or abide by any particular procedures for the purposes of enforcing against collateral provided to it by a Relevant Clearing Member under the Deed of Charge?

Subject to the following discussion, it is our view that the Deed of Charge will be effective in the event of an Insolvency Proceeding in respect of a Relevant Clearing Member.

English law has long recognised the ability of a party that owns an asset to grant a security interest in that asset to another party. In order to do so, the following features are generally required: (i) a clear agreement to give rights in such asset to the secured party; (ii) the right granted in the asset must be an interest rather than a reservation of title to the secured party; (iii) the right in the asset must be given for the purposes of securing an obligation; (iv) the asset must be given in security only rather than as an outright transfer; and (v) the agreement must displace the granting party's right to dispose of the asset free from the security interest.

In the Deed of Charge, the Relevant Clearing Member “assigns, charges and pledges by way of first fixed security interest and by way of continuing security” to LCH all present and future rights, title and interest of the Relevant Clearing Member in certain identified property (the “**Charged Property**”).<sup>105</sup> The Relevant Clearing Member is not free to deal in the Charged Property and may only request the return or repayment of excess collateral, or the provision of replacement collateral of the same or greater value as the substituted collateral.<sup>106</sup> Otherwise, the Charged Property may only be returned to the Relevant Clearing Member when all of the secured obligations to LCH are fully discharged.<sup>107</sup> Based on the foregoing, we believe the Deed of Charge creates a valid security interest in favour of LCH under English law.

As discussed in Section 5.2.1 of this Memorandum, *supra*, the various Insolvency Proceedings available under the laws of this jurisdiction provide for a number of mechanisms that have the potential to interfere with counterparty rights in respect of the insolvent entity. However, these mechanisms generally do not apply in respect of “financial collateral arrangements” protected by the FCA Regulations, “collateral security charges” protected by the SF Regulations or “market charges” protected by Part VII (each as defined in Section 5.2.3, *infra*).

In our view, the Deed of Charge is a “financial collateral arrangement” for purposes of the FCA Regulations because a security interest is granted, in writing, by one non-natural person (*i.e.*, the Relevant Clearing Member) in respect of “financial collateral” (*i.e.*, the Charged Property) in favour of another non-natural person (*i.e.*, LCH) to secure the Relevant Clearing Member's obligations to LCH. The Charged Property is also in the “possession” or “control” of LCH.<sup>108</sup>

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<sup>105</sup> See Clause 2 of the Deed of Charge.

<sup>106</sup> *Id* at Clause 3(2) (referencing sections 1.1.2a and 1.1.3 of Procedures Section 4 (*Collateral*)).

<sup>107</sup> *Id.* at Clause 3(1).

<sup>108</sup> For a more detailed discussion on the definition of “financial collateral arrangement” and the evaluation of the various criteria that must be met, see Section 5.2.3 of this Memorandum, *infra*.

It is also our view that the Deed of Charge is a “collateral security charge” within the meaning of the SF Regulations because it constitutes a “charge” for the purpose of securing rights and obligations arising in connection with a “designated system”.<sup>109</sup> We also believe that the Deed of Charge constitutes a “market charge” under Part VII on the basis that it is a charge granted in favour of a recognised clearing house for purposes of securing obligations in respect of “market contracts”.<sup>110</sup>

Based on the foregoing, in the event of a Relevant Clearing Member’s insolvency, the Deed of Charge would benefit from the cumulative protections applicable to “financial collateral arrangements”, “collateral security charges” and “market charges” from the ordinary law of insolvency in this jurisdiction.

5.2.3 Would LCH have the right to take the actions provided for under the Default Rules (including exercising rights to deal with Contracts under Rule 6 and rights of set-off under Rule 8 but not at this stage considering those actions specifically provided for in the Client Clearing Annex to the Default Rules) in the event that a Relevant Clearing Member was subject to Insolvency Proceedings or Reorganisation Measures? Is it necessary or recommended that LCH should specify that certain Insolvency Proceedings and/or Reorganisation Measures will constitute an Automatic Early Termination Event in accordance with Rule 3 of the Default Rules? If the answer is affirmative, please identify those specific Insolvency Proceedings and/or Reorganisation Measures to which the answer applies and briefly explain your reasoning.

Subject to the remaining response below, LCH would have the right to take the actions provided for under the Default Rules, including exercising rights to deal with Relevant Contracts under Rule 6 and rights of set-off under Rule 8 (collectively, the “**Default Provisions**”), in the event of an Insolvency Proceeding in respect of a Relevant Clearing Member. Specifically, it is our view that Part VII of the Companies Act 1989, as amended (“**Part VII**”), the SF Regulations, and the FCA Regulations, collectively and severally, ensure the enforceability of the Default Provisions against the ordinary UK law of insolvency and protect the Default Provisions against challenges by an insolvency practitioner or by an order of an English court.

It is also our view that, in light of the various protections available in respect of the Default Provisions under the laws of this jurisdiction, it would not be necessary or recommended to specify that certain Insolvency Proceedings constitute Automatic Early Termination Events.

## *Part VII*

Part VII is the cornerstone of the UK’s special insolvency regime applicable to recognised bodies such as LCH.<sup>111</sup> The provisions of Part VII discussed below provide important protections in favour of “market contracts”, “market charges” and “market property” as well as any actions taken pursuant to LCH’s “default rules”. The powers of an officeholder or an

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<sup>109</sup> For a more detailed discussion on the definition of “collateral security” and the evaluation of the various criteria that must be met, see Section 5.2.3 of this Memorandum, *infra*.

<sup>110</sup> For a more detailed discussion on the definition of “market charge” and “market contract”, see Section 5.2.3 of this Memorandum, *infra*.

<sup>111</sup> The Part VII regime applies to several types of market infrastructures, principally “recognised clearing houses”, which include clearing houses that are recognised central counterparties for purposes of EMIR and those that are not. LCH is both a recognised central counterparty and a recognised clearing house for purposes of Part VII. For the sake of completeness, we would note that the Part VII regime also extends certain protections from the ordinary UK law of insolvency to recognised investment exchanges and recognised central securities depositories.

English court to challenge any of the foregoing under the ordinary UK law of insolvency is also strictly limited.

## Enforceability of Market Contracts

A number of protections under Part VII apply to “market contracts”, which are defined in Section 155(1)(d) to include, *inter alia*, “clearing member house contracts” (defined as “a contract between [a recognised CCP] and a clearing member recorded in the accounts of [the recognised CCP] as a position held for the account of a clearing member”) and “clearing member client contracts” (defined as “a contract between [a recognised CCP] and [a clearing member]...which is recorded in the accounts of [the recognised CCP] as a position held for the account of a client...”).<sup>112</sup> A Relevant Clearing Member’s positions in Relevant Contracts held for its own account and for the account of its Clearing Clients fall squarely within the foregoing definitions and hence are “market contracts”.

Section 159(1)(a) of Part VII provides for the enforceability of market contracts, which are not to “be regarded to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of assets” under the ordinary UK law of insolvency. Accordingly, Part VII ensures that all positions in Relevant Contracts held by a Relevant Clearing Member for its own account and for the account of its Clearing Clients are enforceable in the event of the Relevant Clearing Member’s insolvency.

In our view, the reference to “distribution of assets” is intended to cover, *inter alia*, the Statutory Insolvency Set-Off provisions of the Insolvency Proceedings. It is therefore our view that Section 159(1) of Part VII also expressly displaces the application of Statutory Insolvency Set-Off to market contracts during the pendency of a CCP’s default proceedings, which remain enforceable in accordance with their terms in the event of an Relevant Clearing Member’s insolvency.

## Enforceability of Default Rules

The term “default rules” is defined broadly for purposes of Part VII, and includes the rules of a recognised clearing house that set out the actions that can be taken by such clearing house where a person appears to be unable, or likely to become unable, to fulfil its obligations in respect of one or more market contracts connected with the clearing house. The term also includes “all subsequent proceedings” taken by a recognised clearing house under its rules “for the purposes of or in connection with the settlement of market contracts” to which the defaulter is a party.<sup>113</sup> In our view, the term “default rules” is broad enough to include all aspects of the Rulebook that address LCH’s default management of an insolvent Relevant Clearing Member, including the Default Provisions.

Section 159(1)(b) of Part VII provides for the enforceability of LCH’s default rules which are not to be regarded “to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of assets” under the ordinary UK law of insolvency. Accordingly, the Default Provisions, including LCH’s right to deal with Relevant Contracts under Rule 6 and rights of set-off under Rule 8, are valid and enforceable notwithstanding the ordinary UK law of insolvency relating to the distribution of assets. For the reasons set out in the preceding

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<sup>112</sup> See Section 155(1)(a) of Part VII. The term “clearing member client contract” is also extended to include certain back-to-back contracts between a clearing member and its direct client and between a direct client and an indirect client. *Id.*

<sup>113</sup> Section 188(1A) of Part VII expressly includes a recognised central counterparty’s default procedures described in Article 48 EMIR within the scope of such central counterparty’s “default rules”.

section, we believe that Section 159 also expressly displaces the application of Statutory Insolvency Set-Off to the Default Provisions during the pendency of LCH's default proceedings.

Finally, Section 177 of Part VII provides for the application of market property (other than land) held by LCH as margin in relation to a market contract or as default fund contribution. Specifically, Section 177(2) and (3) state that any such property may be applied in accordance with LCH's rules, notwithstanding any prior equitable interest or right, any right or remedy arising from a breach of fiduciary duty, or any right or remedy arising subsequent to the provision of such property to LCH.<sup>114</sup> The only exception to this rule is where LCH has notice of any such interest, right or breach at the time the market property was provided as margin or as default fund contribution.

### Limitations on Insolvency Practitioners and English Courts

The provisions of Part VII described above ensuring the enforceability of the Default Provisions are complemented by a corresponding set of statutory provisions imposing strict limits on the powers of an officeholder and English court to interfere with or otherwise challenge the performance of LCH's obligations under the Default Provisions. These various limitations are set out in more detail below.

Section 159(2) of Part VII provides legal certainty in respect of the protections provided by Section 159(1) by expressly precluding the exercise of any power by a liquidator or administrator or court which could be utilised to prevent or interfere with the settlement of a clearing member house contract or a clearing member client contract in accordance with LCH's default rules or "any action taken to give effect to" such settlement.

Section 164 of Part VII also imposes additional limits on the powers of officeholders and English courts. For example, the provisions of the Insolvency Act granting powers to disclaim onerous contracts and the court's powers to order rescission of contracts do not apply in respect of market contracts or any contract(s) effected by LCH for purposes of realising margin property.<sup>115</sup>

In addition, Section 165 of Part VII provides that no orders under the Insolvency Act may be made in respect of market contracts to which LCH is a party (or which are entered into pursuant to its default rules) or clearing member house contracts or clearing member client contracts – or any disposition of property in respect thereof – on the basis that such contracts constitute transactions at an undervalue, preferences or fraudulent transactions.<sup>116</sup> Similar protections apply in respect of margin provided in connection with market contracts and to the provision, realisation and disposition of property in respect of default fund contributions.<sup>117</sup>

Finally, all net sums certified by LCH following the completion of its default proceedings is provable in English insolvency proceedings and can be taken into account for set-off

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<sup>114</sup> The language in Section 177 of Part VII refers to LCH's "rules", which is necessarily a broader term than LCH's "default rules". Nevertheless, as the scope of this Memorandum is restricted to assessing LCH's rights to use, *inter alia*, market property in the event of a Relevant Clearing Member's insolvency, the fact that LCH's "default rules" are a subset of LCH's "rules" does not, in our view, affect the analysis herein.

<sup>115</sup> See Section 164 of Part VII.

<sup>116</sup> See Section 165(1), (3) of Part VII.

<sup>117</sup> See Section 165(4) and (5) of Part VII.

purposes.<sup>118</sup> This provision ensures that no officeholder or English court may interfere with the Default Provisions relating to the determination of net sums payable between LCH and a defaulting Relevant Clearing Member.

## Protections in respect of Market Charges and Market Property

A “market charge” refers to a charge that is granted, *inter alia*, 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”.<sup>119</sup> The term is therefore specifically intended to cover a charge such as the security interest granted in favour of LCH under the Deed of Charge. The term “market property” is wider than the term “market contract” and refers to any property, other than land, which is held by LCH as margin in relation to market contracts or as a default fund contribution.<sup>120</sup> The term therefore also covers the margin deposited by Relevant Clearing Members in connection with the positions it maintains in Relevant Contracts, as well as the contribution made by that Relevant Clearing Member to the Default Fund.

Market property and market charges benefit from certain protections. Section 175(1) of Part VII permits the secured party under a market charge – such as LCH under the Deed of Charge – to enforce its rights and to realise property subject to the charge notwithstanding that the chargor – here, a Relevant Clearing Member – has entered into administration. In addition, Section 180(1) of Part VII states that, any market property (other than land) held by LCH, or which is subject to a market charge, is protected against any attempts by an unsecured creditor to enforce a judgement or otherwise to take control or possession of such property. Only where the secured party – here, LCH – consents to such proceedings does the protection no longer apply; accordingly, provided LCH grants no such consent, all margin deposited by a Relevant Clearing Member and its associated Default Fund contribution(s) are protected against claims of unsecured creditors in the event of such Relevant Clearing Member’s insolvency

## *SF Regulations*

The SF Regulations implement the EU Settlement Finality Directive<sup>121</sup> under UK law and provide protections from the ordinary UK law of insolvency in respect of, *inter alia*, the “default arrangements” of a “designated system”, and the realisation of “collateral security” in connection with a “designated system”. The SF Regulations also limit the powers of an officeholder and an English court over a designated system’s “default arrangements” and the realisation of collateral security in connection with a “designated system”.

## “Participants” in a “Designated System”

The protections available under the SF Regulations apply in respect of “participants” in a “designated system”. LCH must, as a condition of its authorisation under EMIR, be a

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<sup>118</sup> See Section 163 of Part VII.

<sup>119</sup> See Section 173(1)(b) of Part VII.

<sup>120</sup> See Section 177(1) of Part VII; *see also* Section 188(3A)(b) (defining “default fund contribution” for members of recognised clearing houses). LCH does not accept land to secure positions in cleared swaps.

<sup>121</sup> See Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems. The SF Regulations constitute “EU-derived domestic legislation” for purposes of the EUWA and, as amended from time to time, remain in effect under UK domestic law following the expiry of the post-Brexit transition period.

“designated system” under the Settlement Finality Directive.<sup>122</sup> The Bank of England has duly recognised LCH as a designated system for these purposes.<sup>123</sup>

The SF Regulations define a “participant” in a designated system to include any “institution” as well as the “system operator”. An “institution” includes, *inter alia*, credit institutions and investment firms (as defined in the SF Regulations) and would, in our view, include the Relevant Clearing Members.<sup>124</sup> The “system operator” of a designated system is the entity (or entities) legally responsible for the operation of the system, which in our view clearly includes LCH in respect of its own designated system. LCH is therefore also a “participant” in a designated system for purposes of the SF Regulations.

### Enforceability of Default Arrangements

The term “default arrangements” is defined broadly in the SF Regulations to include “the arrangements put in place by a designated system...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 but not limited to any “default rules” within the meaning of Part VII discussed above. The term is then extended to include any arrangements in respect of netting, closing out of open positions, the application or transfer of collateral security, and the transfer of assets or positions on the default of a system participant. In our view, the term “default arrangements” includes the Default Provisions setting out the actions LCH may take to enforce its security and to net, close-out and liquidate Relevant Clearing Member positions.

The SF Regulations provide that, *inter alia*, (i) the default arrangements in respect of participants in a designated system; and (ii) a contract for the realisation of collateral security in connection with participation in a designated system otherwise than pursuant to its default arrangements, shall in each case not be considered invalid due to any inconsistency with the general UK law of insolvency. For the reasons set out above, LCH and the Relevant Clearing Members are all “participants” in a “designated system” for purposes of the SF Regulations, and will therefore benefit from the foregoing protections.

Most importantly, LCH’s “default arrangements” in respect of “transfer orders” – including the Default Provisions – are not subject to challenge in the event of a Relevant Clearing Member insolvency. LCH may therefore take all actions provided for under the Default Provisions to close out, net and set off the positions of insolvent Relevant Clearing Members.

### Enforceability of Collateral Security

The SF Regulations also provide that a contract for the purpose of realising “collateral security” in connection with participation in a designated system “otherwise than pursuant to its default arrangements” shall not be considered invalid due to any inconsistency with the general UK law of insolvency relating to the distribution of assets. “Collateral security” is defined as, *inter alia*, “any realisable assets provided under a charge...(including...money provided under a

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<sup>122</sup> See Article 17(4) of EMIR.

<sup>123</sup> See Bank of England, “Designated systems under the Settlement Finality Regulations”, available at: <https://www.bankofengland.co.uk/financial-stability/financial-market-infrastructure-supervision>.

<sup>124</sup> Regulation 2(1) of the SF Regulations (defining “institution” to include, *inter alia*, a “credit institution” as well as an “investment firm” as that term is defined in MiFIR).

charge)...for the purpose of securing rights and obligations potentially arising in connection with a [designated] system”.<sup>125</sup>

In our view, the Deed of Charge constitutes “collateral security” under the SF Regulations and therefore benefits from the protections described above. The enforceability of LCH’s right to realise collateral security means that, in the event of a Relevant Clearing Member default, LCH’s right to enforce its security interest under the Deed of Charge is not subject to challenge.

### Limitations on Insolvency Practitioners and English Courts

The SF Regulations provide that the powers of an English insolvency official or an English court to disclaim onerous property, to rescind contracts, avoid property dispositions, or any similar power, do not apply to, *inter alia*: (i) the provision of collateral security; (ii) any contracts for the purpose of realising collateral security, including any disposition of property in respect thereof; and (iii) any disposition of property in accordance with a designated system’s rules relating to the application of collateral security, including in respect of netting, close-out, liquidation and transfer.

These restrictions complement the enforceability provisions referred to in the preceding section and provide the same protections from interference by an insolvency practitioner or court in connection with collateral security. Namely, no insolvency practitioner or court may interfere with LCH’s right to enforce its security interest or to dispose of or transfer a Relevant Clearing Member’s positions and associated collateral, nor may an insolvency practitioner or court use their powers to interfere with any of LCH’s netting, close-out, liquidation or transfer rights set out in its default arrangements, which as noted above include the Default Provisions.

The SF Regulations also ensure the provability of any net sum established by a designated system following completion of its default arrangements. Accordingly, neither an insolvency practitioner nor an English court would be able to challenge the net sums due as determined by LCH pursuant to its default arrangements (including the Default Provisions) in the event of the insolvency of a Relevant Clearing Member.

### *FCA Regulations*

The FCA Regulations implement the EU Financial Collateral Directive<sup>126</sup> under UK law and provide various protections in respect of “financial collateral arrangements” from challenge under the general UK law of insolvency or upon an application by an English insolvency official or by an order of an English court. The term “financial collateral arrangement” includes, as relevant here, a security financial collateral arrangement (“**SFCA**”) and a title transfer financial collateral arrangement (“**TTCA**”).

### Qualifying as a Financial Collateral Arrangement

A “financial collateral arrangement” refers to a written agreement or arrangement that secures the financial obligations of one party (“**collateral-provider**”) owed to another party (“**collateral-taker**”). The collateral-provider and the collateral-taker must both be non-natural

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<sup>125</sup> See Regulation 2(1) of the SF Regulations. This limb of the collateral security definition is referred to as “collateral security in connection with participation in a [designated] system”.

<sup>126</sup> See Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements. The FCA Regulations constitute “EU-derived domestic legislation” for purposes of the EUWA and, as amended from time to time, remain in effect under UK domestic law following the expiry of the post-Brexit transition period.

persons.<sup>127</sup> An SFCA refers to an arrangement whereby the collateral-provider grants a security interest over the relevant “financial collateral”<sup>128</sup> in favour of the collateral-taker, whereas a TTCA refers to an arrangement whereby the collateral-provider transfers legal and beneficial ownership of the financial collateral to the collateral-taker.<sup>129</sup>

For the following reasons, it is our view that the Deed of Charge is an agreement or arrangement that constitutes an SFCA. To so qualify, Regulation 3(1) of the FCA Regulations requires that: (i) the agreement or arrangement be evidenced in writing; (ii) the purpose of the agreement or arrangement be to secure the financial obligations owed to the collateral-taker; (iii) a security interest arise to secure such obligations; and (iv) the financial collateral so delivered be in the “possession” or “control” of the collateral-taker.<sup>130</sup>

The Deed of Charge is in writing, thereby satisfying the first condition. A purpose of the Deed of Charge is to secure the Relevant Clearing Member’s obligations to LCH, in respect of which a security interest is granted in favour of LCH, thereby satisfying the second and third requirements.

In respect of the final requirement – that the financial collateral is in the “possession” or “control” of LCH – it is our view that this condition is met because the collateral is held by LCH, either directly or by a third party on behalf of, for the account of, or under the control and direction of, LCH. We also consider it persuasive that, under Clause 3(2) of the Deed of Charge LCH is entitled to refuse a request by a Relevant Clearing Member to return securities collateral to the extent that it would leave the Relevant Clearing Member undermargined. LCH’s right of refusal in such circumstances should be sufficient to demonstrate “possession” or “control” for purposes of the final requirement.

The position in relation to “possession” or “control” is not free from doubt, however. In *Gray v. G-T-P Group Ltd, Re F2G Realisations Limited (in Liquidation)* [2010] EWHC 1772 (Ch) (“*Gray*”), the court held that it was not possible to have “possession” of intangible securities – such as the financial collateral forming the collateral subject to the Deed of Charge – as a matter of English law. After *Gray*, a definition of “possession” was introduced into the FCA Regulations in 2011, and states that “possession” includes circumstances where financial collateral has been credited to an account of the collateral-taker (or a person acting on the collateral-taker’s behalf) provided that any rights that the collateral-provider may have are

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<sup>127</sup> See Regulation 3(1) of the FCA Regulations.

<sup>128</sup> Regulation 3(1) of the FCA Regulations defines “financial collateral” to include, *inter alia*, cash and “financial instruments” (a term which includes, *inter alia*, shares and other equivalent securities, bonds and other forms of debt instruments traded on the capital markets, and any other securities that are normally dealt in and which give the right to acquire any such shares, bonds, debt instruments or other securities). We have assumed for purposes of this Memorandum that all Collateral constitutes “financial instruments” within the meaning of the FCA Regulations.

<sup>129</sup> Under a TTCA, the collateral-provider provides financial collateral to the collateral-taker on terms that, when the relevant financial obligations are discharged, the collateral-taker is required to transfer legal and beneficial ownership of equivalent financial collateral back to the collateral-provider.

<sup>130</sup> To the extent that the financial instruments posted as collateral constitute “book entry securities collateral” (defined as financial instruments title to which is evidenced by entries in a register or account maintained by an intermediary), we assume that such instruments are maintained in England & Wales. See Regulation 19(2)-(4) of the FCA Regulations (providing that the domestic law where book entry securities collateral is maintained is the relevant law in determining issues relating to proprietary effects, perfecting security interests and the steps required for realising charged property).



limited to the right to substitute financial collateral of similar (or greater) value or to withdraw excess financial collateral.<sup>131</sup>

Following the introduction of this definition, the judge in *Re Lehman Brothers International (Europe) (in Administration)* [2012] EWHC 2997 (Ch) (“**LBIE**”) concluded that it would be possible to have “possession” of intangible securities, however such possession would require more than just custody of the assets and must require some rights to retain the collateral. On the issue of “control”, the FCA Regulations are unhelpfully silent, and the judges in both *Gray* and *LBIE* concluded that this term requires more than “mere” administrative control and the collateral-taker must have a legal right to stop the collateral-provider from dealing in the collateral posted to the collateral-taker.<sup>132</sup> Recently, the European Court of Justice (“**ECJ**”) considered the issue of “possession” under the Financial Collateral Directive and adopted a position largely in line with *Gray* and *LBIE*, holding that “possession” must require “some form of dispossession” of the collateral-provider such that the collateral-taker “is actually in a position to dispose of the collateral when an enforcement event occurs.”<sup>133</sup> Notwithstanding the doubts introduced by *Gray* and *LBIE*, we believe the better view is the one expressed above: for purposes of this Memorandum, the Deed of Charge constitutes an SFCA.

In addition, the Rulebook provides that any cash and non-cash Collateral provided to LCH by a Relevant Clearing Member that is not subject to the terms of the Deed of Charge is provided “on an outright title-transfer basis”.<sup>134</sup> For the following reasons, it is our view that this provision is an agreement or arrangement that constitutes a TTCA.

To qualify as a TTCA, Regulation 3(1) of the FCA Regulations requires that: (i) the agreement or arrangement be evidenced in writing; (ii) the purpose of the agreement or arrangement be to secure the financial obligations owed to the collateral-taker; and (iii) the collateral-provider transfers legal and beneficial ownership in financial collateral to the collateral-taker on terms that when the relevant obligations are discharged the collateral-taker must transfer legal and beneficial ownership of equivalent financial collateral to the collateral-provider.

The Rulebook is in writing, satisfying the first condition, and the purpose of providing the Collateral not subject to the Deed of Charge is to secure the Relevant Clearing Member’s obligations, and, as discussed above, we have assumed that all such Collateral constitutes “financial collateral” for purposes of the FCA Regulations.<sup>135</sup> Finally, once the Relevant Clearing Member’s obligations to LCH are discharged, LCH has undertaken to return equivalent cash and non-cash Collateral to the Relevant Clearing Member.<sup>136</sup> It is therefore our view that the conditions for creating a TTCA are satisfied.

Based on the foregoing, it is our view that that Deed of Charge constitutes an SFCA, and Regulation 20(s) constitutes a TTCA, and the Default Provisions are an “arrangement” that

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<sup>131</sup> Regulation 3(2) of the FCA Regulations.

<sup>132</sup> In *LBIE*, the fact that the collateral-taker was unable to refuse a request by the collateral-provider to return certain collateral meant that necessary “control” was not present.

<sup>133</sup> *Private Equity Insurance Group SLA v. Swedbank AS* [2016] EUECJ C-156/15 (10 November 2016) at ¶¶ 40, 41. The ECJ also noted that “any right of substitution or to withdraw excess financial collateral in favour of the collateral-provider must not prejudice the financial collateral having been provided to the collateral-taker.” *Id.* at ¶ 43.

<sup>134</sup> See Regulation 20(s)(i)-(iii) of the Rulebook.

<sup>135</sup> See note 128, *supra*.

<sup>136</sup> See Regulation 20(u) of the Rulebook.

“forms part” of such SFCA and TTCA. Accordingly, the Default Provisions benefit from the protections set out below against the ordinary UK law of insolvency.

## Enforceability of Close-Out Netting Provisions

One of the principal benefits of the FCA Regulations is that a “close-out netting provision” forming part of an SFCA or TTCA will take effect in accordance with its terms, notwithstanding that the collateral-provider or the collateral-taker is subject to winding-up proceedings or reorganisation measures.<sup>137</sup> The FCA Regulations also expressly state that Statutory Insolvency Set-Off shall not apply to a close-out netting provision.<sup>138</sup>

A “close-out netting provision” is defined as:

*a term of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or any legislative provision under which on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:*

*(a) the obligations of the parties are accelerated to become immediately due and expressed as an obligation to pay an amount representing the original obligation's estimated current value or replacement cost, or are terminated and replaced by an obligation to pay such an amount; or*

*(b) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.<sup>139</sup>*

It is our view that the security, netting and set-off arrangements of the Default Provisions are an “arrangement” of which an SFCA and TTCA “[form] part”, as such provisions are necessarily integrated with the Deed of Charge and Regulation 20(s) as a unitary framework that secures the obligations of a Relevant Clearing Member to LCH. Accordingly, the Default Provisions will be enforceable in accordance with their terms in the event of a Relevant Clearing Member’s insolvency.

## Limitations on Insolvency Practitioners and English Courts

The FCA Regulations also protect financial collateral arrangements from other elements of the ordinary UK law of insolvency. An administrator may not rely on its powers under the Insolvency Act to restrict the enforcement of security interests or to deal with charged property in respect of an SFCA.<sup>140</sup> Nor may any provisions of the Insolvency Act relating to avoidance of property dispositions, avoidance of share transfers, or disclaiming onerous property apply in respect of any property arising under a financial collateral arrangement or a close-out netting

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<sup>137</sup> Regulation 12(2) of the FCA Regulations clarifies that the foregoing protection will not apply where a party to the financial collateral arrangement was on notice regarding the financial status of the other party, including where the first party was aware, or should have been aware, that winding-up proceedings or reorganisation measures had commenced in relation to the other party.

<sup>138</sup> See Regulation 12(4) of the FCA Regulations.

<sup>139</sup> See Regulation 3(1) of the FCA Regulations.

<sup>140</sup> See Regulation 8 of the FCA Regulations.

provision.<sup>141</sup> Nor may such powers be exercised in respect of any security interest arising under an SFCA or to avoid floating charges; the FCA Regulations also disapply certain filing and other perfection requirements in respect of SFCAs.<sup>142</sup>

Accordingly, the FCA Regulations ensure that none of these powers or requirements may be exercised or imposed in a way that would interfere with LCH's powers under the Default Provisions to close-out, net and set off obligations owed between LCH and a defaulting Relevant Clearing Member.

## *BA 2009*

Notwithstanding the various protections available in respect of the Default Provisions set out above, where a Relevant Clearing Member is an SRR Entity, the exercise of certain powers under the SRR could, in the absence of an available exemption, impair LCH's right to take action under the Default Provisions. We discuss below two such powers – the property transfer power and the bail-in power – and certain other relevant provisions of the SRR.<sup>143</sup>

### Property Transfer Power

The SRR permits the transfer of property, rights, and liabilities of the SRR Entity to a third-party purchaser through a “property transfer instrument”.<sup>144</sup> Where a property transfer instrument provides for the transfer of some, but not all, of the property, rights and liabilities of the SRR Entity, such transfer would be a “partial property transfer”. There is a risk that a partial property transfer could “split” the secured obligations from their associated charged assets, which in turn could impact applicable netting arrangements. To protect against such risks, certain partial property transfers are restricted.<sup>145</sup>

Notably, a partial property transfer order may not be made to the extent that it would “have the effect of modifying, modifying the operation of or rendering unenforceable” market contracts, the default rules of, *inter alia*, a recognised clearing house or the rules of, *inter alia*, a recognised clearing house as to the settlement of market contracts not otherwise dealt with under the default rules.<sup>146</sup> For the reasons discussed above, a Relevant Clearing Member's positions in Relevant Contracts held for itself, and for the account of its Clearing Clients, are “market contracts” and the Default Provisions fall within the FSMA definition of “default rules”. Accordingly, where a Relevant Clearing Member is an SRR Entity, no partial property

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<sup>141</sup> See Regulation 10 of the FCA Regulations.

<sup>142</sup> See Regulations 4 and 6A of the FCA Regulations. As discussed in Section 5.1.2 of this Memorandum *supra*, for a floating charge to be enforceable against the liquidator or administrator of an English company, the creditor must ordinarily register the charge with Companies House under the CA 2006.

<sup>143</sup> The discussion in this Memorandum addresses the stabilisation powers that are most likely to affect the netting and other arrangements under the Default Rules. As a result, unless expressly stated otherwise, this Memorandum does not address “share transfer instruments” or “share transfer orders”.

<sup>144</sup> See Sections 33-48A of the BA 2009. A partial property transfer may also be made to a “bridge bank”, which is an entity established and wholly owned by the BoE for purposes of taking on all, or part, of the business of the SRR Entity. The SRR also provides for a “property transfer order” to transfer rights, liabilities or other property of an SRR entity into public ownership. This Memorandum does not address such transfers.

<sup>145</sup> See The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (“**Safeguards Order**”).

<sup>146</sup> Article 7 of the Safeguards Order. The term “recognised clearing house” is defined by reference to Section 285 of FSMA, which includes at paragraph (1)(b)(i) “a central counterparty in relation to which a recognition order is in force”.

transfer may be made under the SRR in a way that would affect LCH's rights in respect of Relevant Contracts or in respect of the actions it may take under the Default Provisions.

If for any reason, the protections in respect of market contracts and default rules were not available to LCH, the Safeguards Order also prohibits the partial transfer of secured liabilities without also transferring the benefit of the security.<sup>147</sup> Accordingly, LCH's security over any property of an insolvent Relevant Clearing Member will be transferred along with any such property to the third-party transferee. LCH would then be able to look to the transferee for performance of the relevant obligations or to enforce its security against the transferee.

## Bail-In Power

Another power under the SRR is the so-called "bail-in tool", which permits the resolution authorities to write down, or convert into equity, the obligations of an SRR Entity.<sup>148</sup> Any such write-down or conversion could in effect wholly or partially eliminate a liability owed by the SRR Entity to its creditors, including LCH under the LCH Agreements. Nevertheless, the bail-in tool is subject to restricted application in respect of certain types of liabilities.

Principally, the bail-in power may not be exercised so as to affect any "excluded liability".<sup>149</sup> Such excluded liabilities include, *inter alia*, liabilities with a remaining maturity of less than 7 days that are: (i) owed to a recognised central counterparty; or (ii) arise from participation in a designated settlement system and are owed to the operator of, or participant in, the system or to the system itself.<sup>150</sup> LCH is a recognised central counterparty as defined in FSMA and is a designated system for purposes of the SF Regulations. It is our view that the liabilities owed by a Relevant Clearing Member to LCH are properly characterised as having a maturity of less than 7 days. Accordingly, LCH benefits from two coextensive, overlapping protections from the bail-in power in respect of "excluded liabilities".

Moreover, a liability is an "excluded liability" to the extent that it is secured.<sup>151</sup> Therefore, no bail-in power may be exercised in respect of any obligations owed to LCH by a Relevant Clearing Member that is an SRR Entity to the extent such obligations are secured. Provided no such obligations remain unsecured, this prong of the "excluded liability" definition should provide a third bar on the application of the bail-in power to LCH's ability to exercise its rights under the Default Rules.

If, for any reason, the protections in respect of excluded liabilities were not available to LCH, there is a separate restriction on the bail-in power in respect of "protected liabilities".<sup>152</sup> For these purposes, a "protected liability" is one that the SRR Entity owes to a particular person where the SRR Entity or its counterparty is entitled to net or set off under a set-off arrangement,

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<sup>147</sup> Article 5 of the Safeguards Order.

<sup>148</sup> See Section 12A of the BA 2009.

<sup>149</sup> *Id.* at Section 48B(4)(b).

<sup>150</sup> *Id.* at Section 48B(8)(e), (ea).

<sup>151</sup> *Id.* at Section 48B(8)(b).

<sup>152</sup> See The Banking Act 2009 (Restriction of Special Bail-In Provision, etc.) Order 2014 ("Bail-In Order").

netting arrangement or title-transfer collateral arrangement.<sup>153</sup> A protected liability may nevertheless be subject to the bail-in power to convert the net sum due after netting or set-off.<sup>154</sup>

## Other Relevant Provisions

In addition to the exercise of its powers under the SRR, the BoE has the power to suspend: (i) the performance of certain contractual obligations; (ii) the right of a secured party to enforce its security against an entity in resolution; and (iii) the termination rights of a counterparty to agreement “qualifying contract” with an entity in resolution.<sup>155</sup> The BoE’s powers in this regard do not apply in respect of agreements with “excluded persons”, a term which includes, *inter alia*, a recognised central counterparty as well as the operator of a designated settlement system.<sup>156</sup> LCH is both a recognised central counterparty for purposes of FSMA as well as the operator of a settlement system designated under the SF Regulations, in which case it qualifies as an “excluded party” under two headings, thereby ensuring that the BoE’s suspension powers cannot be applied to its rights under the Default Provisions.

Finally, a counterparty is restricted from terminating an agreement on the basis of the exercise of, *inter alia*, stabilisation powers under the SRR, provided that the substantive obligations under the agreement continue to be performed.<sup>157</sup> In addition, HMT has the power to change UK law (other than the BA 2009) to enable the SRR powers to be used effectively.<sup>158</sup>

5.2.4 Is there a “suspect period” prior to Insolvency Proceedings and/or Reorganisation Measures where Relevant Contracts with a Relevant Clearing Member could be avoided or challenged and, if so, what are the grounds? What are the risks for LCH in entering into Relevant Contracts and in taking collateral in respect of those Relevant Contracts during such a period? Are any special protections or exemptions for the relevant arrangements, from avoidance or challenge, available under the law of the Relevant Jurisdiction in respect of contracts in financial markets?

In general, several provisions of the Insolvency Act permit an insolvency practitioner or an English court to set aside transactions entered into by an insolvent party:

- *Transactions at an Undervalue.* An insolvency practitioner may ask an English court to set aside a transaction whereby the debtor agreed to dispose of an asset for either no consideration, or consideration which is significantly less than that originally provided by the debtor to acquire the asset.<sup>159</sup>

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<sup>153</sup> *Id.* at Article 4(2) of the Bail-In Order. To qualify, the liability must not have already been, or treated as if it had been, converted into a net debt, claim or obligation.

<sup>154</sup> *Id.* at Article 4(6).

<sup>155</sup> *See* Sections 70A-C of the BA 2009.

<sup>156</sup> *Id.* at Section 70D.

<sup>157</sup> *See* Section 48Z of the BA 2009. The restriction applies expressly to the exercise of “crisis management measures” (of which the stabilisation powers form part), “crisis prevention measures” and recognised third-country resolution actions. Accordingly the scope of the restriction applies beyond the exercise of the transfer and bail-in powers discussed herein.

<sup>158</sup> *Id.* at Section 75.

<sup>159</sup> *See* Section 238 of the Insolvency Act (winding-up) and Section 339 of the Insolvency Act (administration).

- *Preferences.* An insolvency practitioner may also request an English court to set aside a transaction that has the effect of putting a creditor in a better position than it would otherwise have been in the event of the debtor’s insolvency.<sup>160</sup>

In the case of both transactions at an undervalue and preferences, the relevant agreement must have either been entered into six months prior to the onset of insolvency (or two years in respect of a “connected person”) and the debtor must either have at that time been unable to pay its debts (as described in Section 123 of the Insolvency Act) or become unable to pay its debts as a result of entry into such agreement.<sup>161</sup>

An English court may also avoid a transaction at an undervalue that constitutes a “transaction defrauding creditors”.<sup>162</sup> We have assumed for purposes of this Memorandum that all Relevant Contracts have been entered into for *bona fide* commercial purposes, in which case neither LCH nor any Relevant Clearing Member will be engaged in activities for the purpose of putting assets beyond the reach of a creditor or otherwise prejudicing the interests of a creditor.

The provisions of the Insolvency Act set out above that permit an insolvency practitioner or an English court to avoid certain transactions are subject to strict limits in the event of a Relevant Clearing Member insolvency. Please see Section 5.2.3 of this Memorandum, *supra*, and Section 5.3.4 of this Memorandum, *infra*, for a discussion of the ways in which Part VII, the SF Regulations and the FCA Regulations, individually and collectively, disapply these avoidance powers in such circumstances.

5.2.5 Is there relevant netting legislation in the Relevant Jurisdiction that, in the context of Insolvency Proceedings or Reorganisation Measures in respect of a Relevant Clearing Member, might apply as an alternative to the relevant arrangements set out in the Default Rules?

As noted in Section 5.3.1 of this Memorandum, *supra*, Statutory Insolvency Set-Off is a general principle of Insolvency Proceedings under the laws of this jurisdiction, and provides for the automatic and self-executing set-off of all amounts due and owing between a creditor and a debtor in respect of their mutual dealings.<sup>163</sup> Nevertheless, and as discussed in more detail in Section 5.2.3 of this Memorandum, *supra*, both Part VII and the FCA Regulations displace the application of Statutory Insolvency Set-Off and preserve the exercise of LCH’s rights under the Default Provisions in the event of a Relevant Clearing Member’s insolvency.<sup>164</sup>

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<sup>160</sup> *Id.* at Section 239 (winding-up) and Section 340 (administration).

<sup>161</sup> *Id.* at Section 240(1)-(2).

<sup>162</sup> *See* Section 423 of the Insolvency Act.

<sup>163</sup> *See* Insolvency Rule 14.24 (administration); Insolvency Rule 14.25 (winding-up); Rule 72 of the Bank Insolvency Rules (bank insolvency); Rule 73 of the BS Insolvency Rules (building society insolvency); and Rule 164 of the IB Rules (investment bank special administration).

<sup>164</sup> We note in this regard that the Part VII protections would not displace Statutory Insolvency Set-Off to the extent that LCH fails to take action under the Default Rules in respect of a Relevant Clearing Member subject to certain types of insolvency events and further fails to act within 3 business days of receiving notice from the BoE. *See* Section 167 of the CA 2009. In preparing this Memorandum, we have assumed that, in all cases, LCH takes action under its Default Rules in the event of Insolvency Proceedings of a Relevant Clearing Member.

- 5.2.6 Can a claim for a close-out amount be proved for in Insolvency Proceedings without conversion into the local currency?

The local currency of this jurisdiction is Sterling and, accordingly, no such conversion will be necessary in connection with Insolvency Proceedings of a Relevant Clearing Member.

## 5.3 Client Clearing

- 5.3.1 Please opine on the availability and effectiveness of any law, regulation or statutory provision (having the force of law) in the Relevant Jurisdiction which (if so designated by LCH) would be expected to qualify as an Exempting Client Clearing Rule. Please clarify whether the relevant Rule would be expected to apply to Relevant Clearing Members of all entity types or only to certain entity types.

If, and to the extent that, you consider such an Exempting Client Clearing Rule to be available, please (i) assume for the purposes of answering the following Questions that LCH will rely upon the existence of the relevant Exempting Client Clearing Rule and will not require those Relevant Clearing Members to which that Rule applies to enter into a Security Deed; and (ii) ignore Questions 5.3.3 to 5.3.5.

In our view, the provisions of Part VII set out in the responses below constitute an Exempting Client Clearing Rule in respect of the Relevant Clearing Members addressed herein.

- 5.3.2 If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceedings or Reorganisation Measures in respect of that Relevant Clearing Member and (ii) seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the Relevant Clearing Member or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?

We are not aware of any provisions of English law that would prevent LCH from exercising its rights under the Client Clearing Annex where a Relevant Clearing Member is a Defaulter but not by reason of the commencement of Insolvency Proceedings.

- 5.3.3 If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceedings or Reorganisation Measures in respect of that Relevant Clearing Member and (ii) seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such Clearing Client, could the Relevant Clearing Member or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

Please see the response to Section 5.3.2 of this Memorandum, *supra*.

- 5.3.4 If (i) following the commencement of Insolvency Proceedings, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event)); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?

The exercise of LCH’s rights to port the Client Contracts and Account Balance to a Backup Clearing Member in such circumstances would be effective in light of the protections afforded to “transfers” of “qualifying collateral arrangements” and “qualifying property transfers” under Part VII.

For these purposes, a “qualifying collateral arrangement” refers, *inter alia*, to contracts and contractual arrangements for, or arising out of, the provision of property as margin to LCH and recorded in LCH’s accounts as being held for the account of a client (or group of clients).<sup>165</sup> Plainly, therefore, the term includes the provision of cash and non-cash Collateral by Relevant Clearing Members in respect of its Clearing Clients, and the maintenance thereof by LCH in segregated client accounts, as provided for in the Rulebook.

The term “transfer” includes an assignment or a novation as well as the termination or closing out of a clearing member client contract or client trade and establishing an equivalent position between different parties.<sup>166</sup> For clearing member client contracts recorded in the accounts of a recognised CCP as a position held for the account of an indirect client or group of indirect clients, the clearing member client contract is treated as transferred if the position is transferred to a different account at the recognised CCP. We believe that LCH’s porting rights under the Client Clearing Annex constitute a “transfer” for these purposes.

A “qualifying property transfer” refers to, *inter alia*, transfers representing the termination/close out value of clearing member client contracts from a defaulting clearing member to a non-defaulting clearing member in accordance with LCH’s default rules.<sup>167</sup> The term also expressly includes “transfers of property made in accordance with Article 48(7) of [EMIR]”.<sup>168</sup> We believe this term should accordingly include any action taken by LCH pursuant to the Client Clearing Annex to port positions and assets of Clearing Clients to a Backup Clearing Member.

Section 159(1)(g) of Part VII provides that LCH’s right to transfer qualifying collateral arrangements in conjunction with the transfer of clearing member client contracts shall not be considered invalid due to inconsistency with the ordinary UK law of insolvency relating to the distribution of assets. Section 159(h) of Part VII makes a similar provision in relation to qualifying property transfers. Accordingly, the Default Provisions, as they relate to the porting of positions and assets of Clearing Clients in the event of a Relevant Clearing Member’s insolvency, are valid and enforceable in accordance with their terms.<sup>169</sup>

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<sup>165</sup> See Section 155A(2)(a)-(b) of Part VII.

<sup>166</sup> See Section 189A of Part VII.

<sup>167</sup> See Section 155A(4)(b)(i)-(iii) of Part VII.

<sup>168</sup> See Section 155A(4)(a) of Part VII.

<sup>169</sup> For the reasons set out in Section 5.2.3, *supra*, we believe that Section 159 of Part VII also expressly displaces the application of Statutory Insolvency Set-Off to the “transfer” of “qualifying collateral arrangements” and “qualifying property transfers” during the pendency of a CCP’s default proceedings.



Moreover, Section 159(2) of Part VII provides legal certainty in respect of the protections provided by Section 159(1) by expressly precluding the exercise of any power by a liquidator or administrator which could be utilised to undo or disturb: (i) the transfer or settlement of a clearing member client contract in accordance with LCH's default rules; (ii) the transfer of a qualifying collateral arrangement in conjunction with a transfer of clearing member client contracts; (iii) any action taken to give effect to any of the matters referred to in (i) or (ii); and (iv) any action taken to give effect to qualifying property transfer.

Part VII also provides that the provisions of the Insolvency Act granting powers to disclaim onerous contracts and the court's powers to order rescission of contracts do not apply in respect of: (i) qualifying collateral arrangements; (ii) the transfer of, *inter alia*, a clearing member client contract or qualifying collateral arrangement; and (iii) a qualifying property transfer.<sup>170</sup>

5.3.5 If (i) following the commencement of Insolvency Proceedings, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event)); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such Clearing Client, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

As noted in Section 5.3.4, *supra*, Part VII provides certain protections in respect of “qualifying property transfers”. As also noted above, the term “qualifying property transfer” expressly includes “transfers of property made in accordance with Article 48(7) of [EMIR]”.<sup>171</sup> Such transfers include “any balance owed by the CCP after the completion of the clearing member’s default management process by the CCP [which] shall be readily returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of the clients”.

In our view, the return of the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such Clearing Client falls squarely within the definition of “qualifying property transfer” under Part VII. The exercise of LCH’s rights under the Default Provisions to return the Client Clearing Entitlement benefit from the protections afforded to “qualifying property transfers” described in greater detail in Section 5.4.3, *supra*.

5.3.6 If (i) following the implementation of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event)); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the representative appointed to reorganise/manage the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?

In our view, these circumstances are most likely to apply to a Relevant Clearing Member that is an SRR Entity subject to the property transfer power under the SRR without also being subject to Insolvency Proceedings. In such a case, and as described in greater detail in Section 5.2.3, *supra*, the Safeguards Order prohibits the making of a partial property transfer to the

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<sup>170</sup> See Section 164 of Part VII.

<sup>171</sup> See Section 155A(4)(a) of Part VII.

extent that it would modify or render unenforceable market contracts (a term which includes Client Contracts) or the default rules of a CCP (a term which includes the Default Provisions).

Accordingly, a partial property transfer under the SRR may not interfere with LCH's rights to port Client Contracts and the Account Balance to a Backup Clearing Member in accordance with the Client Clearing Annex.

5.3.7 If (i) following the implementation of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event)); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such Clearing Client, could the representative appointed to reorganise/manage the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

The protections against partial property transfers afforded to market contracts and the default rules of a CCP under the Safeguards Order described in Section 5.3.6, *supra*, would apply equally to the return of the Client Clearing Entitlement to the Clearing Client or to the Defaulter for the account of the Clearing Client.

5.3.8 Would the Security Deed provide an effective security interest under the laws of the Relevant Jurisdiction over the Account Balance or Client Clearing Entitlement in favour of the relevant Clearing Client?

In accordance with your instructions, we have not responded to this question.

5.3.9 Are there any perfection steps which would need to be taken under the laws of the Relevant Jurisdiction in order for the Security Deed to be effective?

In accordance with your instructions, we have not responded to this question.

5.3.10 Is there a risk of a stay on the enforcement of the Security Deed in the event of Insolvency Proceedings or Reorganisation Measures being commenced in respect of a Relevant Clearing Member?

In accordance with your instructions, we have not responded to this question.

5.3.11 Please provide brief details of any other significant legal or regulatory issues which might be expected to arise in connection with the provision by a Relevant Clearing Member of Client Clearing Services and which are not covered by the questions above.

As of the date of this Memorandum, there are no other significant legal or regulatory issues that are expected to arise under the laws of this jurisdiction in connection with the provision of Client Clearing Services by a Relevant Clearing Member beyond those already addressed herein.

## 5.4 Settlement Finality

### 5.4.1 Would the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member affect the finality of settlement of transfers of funds or securities (or both) from the Relevant Clearing Member to LCH? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.

The SF Regulations provide certain protections in respect of “transfer orders”, which are defined as:

(a) *an instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit institution, a central bank, a central counterparty or a settlement agent, or an instruction which results in the assumption or discharge of a payment obligation as defined by the rules of a designated system (**payment transfer order**); or*

(b) *an instruction by a participant to transfer the title to, or interest in, securities by means of a book entry on a register, or otherwise (**securities transfer order**).<sup>172</sup>*

As noted in Section 5.2.3, *supra*, LCH is a “designated system” under the SF Regulations as a condition of its authorisation under EMIR.

The consequence of these definitions is that: (i) the clearing of a Relevant Contract by a Relevant Clearing Member at LCH for itself or for the account of a Clearing Client involves one or more “transfer orders” being effected through LCH’s designated system; and (ii) any instruction by LCH to transfer cash or non-cash Collateral to a Relevant Clearing Member, or vice versa, through LCH’s system in respect of a Relevant Contract is also a “transfer order”.<sup>173</sup>

The SF Regulations provide that transfer orders shall not be considered invalid due to any inconsistency with the general UK law of insolvency relating to the distribution of assets.<sup>174</sup> In addition, the SF Regulations provide that the powers of an English insolvency official or an English court to disclaim onerous property, to rescind contracts, avoid property dispositions, or any similar power, do not apply to transfer orders, including any dispositions of property in respect thereof.

Note that a transfer order does not benefit from the foregoing protections if it is given after the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member, unless it is given on the day of commencement and it is proven that it was given without notice of the insolvency.<sup>175</sup> This exception does not however apply to any transactions entered into in accordance with the default arrangements of a designated system, such as in connection with

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<sup>172</sup> See Regulation 2(1) of the SF Regulations.

<sup>173</sup> Each “Payment Transfer Order” and “Securities Transfer Order”, as defined in the Settlement Finality Regulations, constitutes a “transfer order” for purposes of the SF Regulations.

<sup>174</sup> For the sake of completeness, we note that where a transfer order is also a market contract, the provisions of the SF Regulations relating to the effectiveness of such transfer order and the onset of insolvency take precedence over Part VII.

<sup>175</sup> See Regulation 20 of the SF Regulations.

LCH's default management of an insolvent Relevant Clearing Member, including the Default Provisions.<sup>176</sup>

5.4.2 Are there any circumstances (such as the commencement of Reorganisation Measures) which might give rise to the loss of finality protections before the commencement of Insolvency Proceedings? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.

Please see the response to Section 5.4.1 of the Memorandum, *supra*.

\* \* \* \* \*

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<sup>176</sup> See Regulation 14 of the SF Regulations.