

**DATED 9 MARCH 2023**

**MEMORANDUM OF LAW**

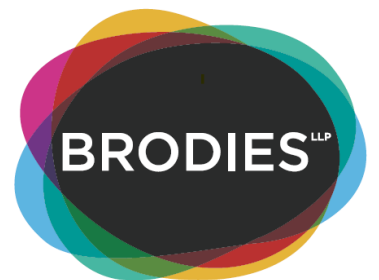
**prepared for**

**LCH LIMITED**

**in respect of**

**the validity and enforceability of the clearing documentation of  
LCH Limited under the laws of Scotland**

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**DATE: 9 MARCH 2023**

## **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 Scotland (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 as applicable in this jurisdiction by virtue of the European Union (Withdrawal Act) 2018 (the “**EUWA**”), as amended, and as amended from time to time in accordance with UK law.

This Memorandum is prepared in relation to the law applied in Scotland as at the date hereof.

## **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 (each, a "**Scottish Bank**");
  - (ii) an investment firm as defined in Section 258A of the Banking Act 2009 ("**BA 2009**") (each, a "**Scottish Investment Firm**");
  - (iii) an investment bank as defined in Section 232 of the BA 2009 (each a "**Scottish Investment Bank**");
  - (iv) a building society formed and registered under the Building Societies Act 1986 ("**BSA 1986**") or otherwise deemed registered thereunder (each, a "**Scottish Building Society**");

in each case that is a company either formed and registered in Scotland under the Companies Act 2006 ("**CA 2006**") (or the "former Companies Acts" as defined therein) or incorporated in Scotland by royal charter, or established in Scotland under the BSA 1986; or

  - (v) a foreign company organised or incorporated and regulated as a bank or an investment firm in another jurisdiction but operating through a branch located in Scotland (a "**Scottish Branch**");
- (d) LCH and each Relevant Clearing Member are duly formed and, at all times, are validly existing and organised and have separate legal personality 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) The obligations arising under and pursuant to the LCH Agreements are legal, valid and binding obligations of LCH and each Relevant Clearing Member under English law;
- (i) LCH and each Relevant Clearing Member have entered into each Relevant Contract for *bona fide* commercial purposes and on an arm's-length basis;
- (j) the obligations assumed between LCH and each Relevant Clearing Member under the LCH Agreements are mutual;
- (k) 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;
- (l) there are no other agreements, instruments or arrangements between LCH and any Relevant Clearing Member which conflict with, modify or supersede the LCH Agreements;
- (m) LCH and each Relevant Clearing Member will perform (and not waive) their respective obligations under the LCH Agreements in accordance with their terms;
- (n) 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;
- (o) 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;
- (p) LCH is at all relevant times solvent and not subject to insolvency, reorganisation or similar proceedings under the laws of any jurisdiction;

- (q) 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**”));
- (r) the Charged Property is held by an “intermediary” (as defined in the FCA Regulations) and the “relevant account” (as defined in the FCA Regulations) and the Charged Property and the Charged Assets are located in England and Wales;
- (s) 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;
- (t) 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;
- (u) 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;
- (v) no Relevant Clearing Member is subject to ongoing insolvency proceedings as of the date of this Memorandum; and
- (w) 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.

- (a) The views expressed in this Memorandum are based solely on the laws of Scotland as in effect on and as applied by the Scottish courts or, where expressly stated, a duly constituted arbitral tribunal with its seat in Scotland, 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 of the type which Scottish 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) A Scottish court will not necessarily grant a particular remedy because:
    - (A) in the case of discretionary remedies of the court, the court decides not to exercise its discretion in that particular instance, e.g. an order for the remedy of specific implement 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 Prescription and Limitation (Scotland) Act 1973 as amended, or may be or become subject to a defence or plea of retention, set-off, compensation or counterclaim or balancing of accounts in insolvency;
  - (iii) the enforcement of an obligation may be limited by the provisions of Scots law which may hold an agreement to have been frustrated or irritated by a supervening event; and
  - (iv) the provisions of Scots law relating to misrepresentation, mistake or error 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 Scottish 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 as a matter of Scots law.

#### 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)?

There are no specific statutory limitations or regulatory requirements which would limit the capacity of an appropriately authorised (to the extent that such authorisation is required) Relevant Clearing Member to enter into the LCH Agreements. 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 activity” relating to 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 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



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 applicable in this jurisdiction 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-authorised 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.

The potential limitations imposed by the constitutional documents, and the restrictions limiting the capacity of directors of a Relevant Clearing Member to enter into the LCH Agreements on behalf of the Scottish Clearing Member are discussed at section 5.1.3 below.

### 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

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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).

to a Relevant Clearing Member or are there any special local arrangements for the recognition of overseas clearing houses in these circumstances?

LCH would not be deemed to be domiciled, resident or carrying on business in this jurisdiction by virtue solely of providing clearing services to a Relevant Clearing Member. However, for regulatory purposes LCH would be deemed to be carrying on regulated activities in this jurisdiction. In any event, and in respect of the second question, the relevant regulatory system applies in this jurisdiction in the same manner as in England and Wales. 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.

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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”, which was, and remains, another category of exempt person under FSMA.

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

*Capacity*

A Scottish company must generally act in accordance with the objects for which it was formed. Nevertheless, a Scottish company's objects are presumed to be unrestricted unless any specific limitations are contained in its articles of association.<sup>7</sup> Moreover, the validity of any act performed by a Scottish 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 a Relevant Clearing Member that is a royal charter corporation – 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 Scottish 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*

A counterparty that deals with a Scottish 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>10</sup> For these purposes, there is a presumption of good faith on behalf of the counterparty, which shifts the burden to the Scottish company to demonstrate both the existence of bad faith and its own lack of authority.<sup>11</sup> As a result, a Scottish 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*

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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 40 of the CA 2006.

<sup>11</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.*

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 appropriate documentation establishing the authority of the signatories executing the LCH Agreements on behalf of a Relevant Clearing Member.<sup>12</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>13</sup>

Searches at Companies House in Edinburgh should also be carried out to ensure that a Relevant Clearing Member which is registered with the Registrar of Companies is not insolvent, although such searches cannot be fully relied upon. Not all insolvency notices need to be filed with the Registrar and insolvency orders, notifications or resolutions which do have to be filed may not yet have been so filed, or may not yet be publicly available, at the time the searches are undertaken.

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.

In our view the formal validity, including the execution formalities, of the LCH Agreements is a matter for English law. Subject to our comments below, and any requirements of the Relevant Clearing Member's constitutional documents or other internal execution policies or protocols, Scots law requires compliance with no further formalities beyond the execution requirements (for wet ink execution or electronic execution) under the laws of England and Wales as stated in the memorandum for that jurisdiction in order for the Relevant Clearing Member to enter into the LCH Agreements.

*Companies*

As a matter of Scots law, the LCH Agreements must be executed (either in wet ink or electronically) by or on behalf of a Relevant Clearing Member which is a company for the purposes of the CA 2006 by a director, or

<sup>12</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). Where a signatory is an authorised signatory the power of attorney appointing the authorised signatory should be obtained.

<sup>13</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".

by the secretary of the company or by a person authorised to sign the document on its behalf<sup>14</sup>. An authorised signatory is not required to be a director or secretary of the company.

*Royal Charter Corporations and Building Societies*

The LCH Agreements may be executed (either in wet ink or electronically) by or on behalf of an unregistered company – such as a Relevant Clearing Member that is a royal charter corporation – or by or on behalf of a Relevant Clearing Member which is a Building Society by a member of the entity's governing board (or a member of the entity if there is no governing board), or by the secretary of the entity or by a person authorised to sign the document on its behalf.<sup>15</sup> 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.

*The CM Agreement and the Deed of Charge*

The signature page of the CM Agreement and the Deed of Charge requires two signatories to sign in the name of the Relevant Clearing Member. Therefore, provided one of the signatories is a director or secretary or authorised signatory (or, in the case of a Relevant Clearing Member which is royal charter corporation or a Building Society, one of the office holders indicated above) that person's signature (whether wet ink or electronic) will, subject to the clarification above regarding royal charter corporations, constitute valid execution of the CM Agreement and Deed of Charge by the Relevant Clearing Member under Scots law.

If a Scottish court were to determine that the CM Agreement, Deed of Charge or Security Deed ought, notwithstanding the choice of English law as the contractual governing law, to have been executed in accordance with the formalities of Scots law, additional evidence to demonstrate the Relevant Clearing Member's intention to be bound by the LCH Agreements may require to be led, as execution in the manner outlined above, while valid, is not (unless execution is by 'qualified electronic signature'<sup>16</sup>) self-evidencing under Scots law.<sup>17</sup> We consider the risk of a Scottish court taking such an approach to be low.

For the sake of completeness, we would note that a Scottish company registered under the CA 2006 is ordinarily required to register certain “charges” with Companies House.<sup>18</sup> Failure to do so within 21 days of

<sup>14</sup> See Schedule 2, paragraph 3(1) of the Requirements of Writing (Scotland) Act 1995 (“**ROWA**”) for wet ink execution of traditional documents by companies, and Regulation 5(4) of the Electronic Documents (Scotland) Regulations 2014 (“**EDRs**”) for electronic execution by such entities.

<sup>15</sup> See paragraph 3 of Schedule 1 to the Unregistered Companies Regulations (“**UCRs**”) (applying Section 48 to unregistered companies, a term which includes royal charter corporations (unless these were formed for the purpose of carrying on a business that does not have the acquisition of gain by the body or its individual members for its object, which is unlikely in the current circumstances)) and Schedule 2, paragraph 5 of ROWA (wet ink execution) and Regulation 5(6) of the EDRs (electronic execution), which apply to bodies corporate which are not companies registered under the CA 2006, which includes royal charter corporations and Building Societies.

<sup>16</sup> See Regulation 3 of the EDRs. A 'qualified electronic signature' under the EDRs is a qualified electronic signature as defined in Article 3(12) of Regulation (EU) No 910/2014 of the European Parliament and of the Council on electronic identification and trust services for electronic transactions in the internal market.

<sup>17</sup> Additional evidence might include the applicable minute of the directors meeting(s) at which authorisation of entry into the LCH Agreements took place and other documentation relating to the Relevant Clearing Member's application for admission as a Clearing Member.

<sup>18</sup> *Id.* at Section 859A.

the charge's "creation" renders the charge void against any liquidator, administrator or creditor of the company.<sup>19</sup> For these purposes, a "charge" includes a mortgage such as the Deed of Charge.<sup>20</sup> Nevertheless, the registration requirement does not apply in relation to any charges created or arising under a "security financial collateral arrangement".<sup>21</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.

The requirements in relation to registering the Deed of Charge with Companies House are not relevant to royal charter corporations as the UCRs do not apply Section 859A CA 2006 to unregistered companies. Scottish Building Societies are under no obligation to register security with the Financial Conduct Authority, which is the registrar for building societies<sup>22</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 a Scottish court would give effect to this choice of law.

##### *Governing Law – Contractual Obligations*

A Scottish court will determine the validity and enforceability of a governing law clause relating to contractual obligations arising under a contract in accordance with legislation known as Rome I.<sup>23</sup> The foundational principle of the Rome I framework is to provide maximum freedom for contracting parties to select the governing law of their agreement.<sup>24</sup> Therefore, where Rome I applies, the express choice of English law in Regulation 51(a) will be recognised by a Scottish court unless an exemption applies to modify the choice of law.

<sup>19</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>20</sup> *Id.* at Section 859A(7)

<sup>21</sup> See Section 859A(6)(c) of the CA 2006 and Section 4(4) of the FCA Regulations.

<sup>22</sup> See Section 5(2) of the BSA 1986.

<sup>23</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, 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>24</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".)

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>25</sup> For purposes of this analysis, LCH and the Relevant Clearing Members have chosen English law, LCH is, we understand, physically located in England and Wales and is a common party to the LCH Agreements, the Relevant Clearing Members are physically located in this jurisdiction, noting assumption at paragraph 3(r) the relevant accounts are located in England and Wales, and that England and Wales is the jurisdiction in which all (or nearly all) obligations under the LCH Agreements and the Relevant Contracts will occur.

Finally, there is an exemption that applies where a parties' choice of law is "manifestly incompatible" with the public policy of the forum.<sup>26</sup> We are unaware of any legal authority that would support the conclusion that a Scottish 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).

Accordingly, we do not believe any of the exemptions are likely to apply as a matter of Scots law.

To the extent that Rome I does not apply, the choice of English law may be overridden in certain limited circumstances at Scots common law.

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

A Scottish court will determine the governing law applicable to non-contractual obligations in accordance with legislation known as Rome II.<sup>27</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>28</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>29</sup>

Rome II also contains a "public policy" exemption similar to Rome I.<sup>30</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 a Scottish court

<sup>25</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>26</sup> See Article 21 of Rome I.

<sup>27</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>28</sup> See Article 14(1) of Rome II ("The parties may agree to submit non-contractual obligations to the law of their choice...").

<sup>29</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).

<sup>30</sup> *Id.* at Article 26.

to refuse a choice of English governing law. Accordingly, we believe a Scottish court would generally uphold the parties' choice of English law to govern non-contractual obligations.

#### *Governing Law – security rights*

A Scottish court is likely to determine that the *lex situs* (or related principles) governs the creation of security rights in the Charged Property and the Charged Assets regardless of the choice of governing law under the Deed of Charge and the Security Deed. Noting the assumption at paragraph 3(r) that the Charged Property and Charged Assets are located in England and Wales, a Scottish court is likely to treat the law of England and Wales as the *lex situs* and we would refer to the England and Wales Memorandum on this point regarding the Deed of Charge and the Security Deed.

#### *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 (Scotland) Act 2010 (“**A(S)A 2010**”). 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. Section 6 of the A(S)A 2010 imposes Scots law as governing the arbitration as a default but only where the arbitration agreement does not specify the law which is to govern it. Where the arbitration agreement does specify the law which is to govern it, that law will be recognised.

We note in this regard that the Rulebook makes reference to the LCIA Arbitration Rules of The London Court of International Arbitration (“**LCIA Rules**”). 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”.

For the reasons set out above, we believe that the laws of this jurisdiction would recognise the parties' choice of English law (to the extent it is established as the law of the 'Relevant Jurisdiction' under the Rulebook 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 and Wales, a Scottish court will apply the terms of the Civil Jurisdiction and Judgments Act 1982 (“**CJJA**”).

Under the CJJA, a jurisdiction clause, including an exclusive jurisdiction clause, designating the courts of one of part of the United Kingdom shall be given effect provided the jurisdiction agreement is effective under the



law of that part of the United Kingdom. That is a matter of English law, but if the exclusive jurisdiction clause is effective to confer jurisdiction under English law then a Scottish court would be bound to recognise the exclusive jurisdiction of the court of England and Wales over the dispute and therefore decline to consider the case for reason of a lack of jurisdiction to do so.

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

A Scottish court will uphold a judgment of an English court or an English arbitration award upon (i) enforcement of the judgment under the procedures in the CJJA and applicable subordinate legislation or rules of court or (ii) if the CJJA does not apply, enforcement of such a judgment through an action of decree-conform under common law in the Court of Session in Scotland. The requirements for the judgment to be upheld through an action of decree-conform are that (1) the court which issued the judgment had jurisdiction and acted judicially with no element of unfairness, (2) such judgment was final, not obtained by fraud, or a revenue action, remained capable of enforcement in the place it was pronounced and was not contrary to natural justice, and (3) enforcement of the judgment is not contrary to Scottish public policy. Provided each of these requirements is met, we would expect a Scottish court to enforce a court judgment or 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?

A Scottish court may not permit enforcement of foreign judgments where they are in contravention of Scottish public policy rules. These rules relate primarily to fraud and attempts to circumvent mandatory rules of Scots law. We do not believe the arrangements set out in the CM Agreement, the Deed of Charge and the Security Deed would breach Scottish public policy rules.

## 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 3 or Rule 5 of the Default Rules? Are any other events or procedures not envisaged in Rule 3 or Rule 5 of the Default Rules relevant?

If a Relevant Clearing Member that is a Scottish 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 (Scotland)(Receivership & Winding up) Rules 2018 and the Insolvency (Scotland) (Company Voluntary Arrangements and Administration) Rules 2018 (together the “**Insolvency Rules**”).<sup>31</sup> In addition, a Relevant Clearing Member that is a Scottish

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<sup>31</sup> Note that, as provided below, certain proceedings in respect of a Relevant Clearing Member continue to apply the Insolvency (Scotland) Rules 1986.

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, 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 Scottish Banks may be subject to bank insolvency or bank administration, certain Scottish Investment Banks may be subject to investment bank special administration, and Scottish Building Societies may be subject to building society insolvency or building society special administration.

In addition, certain Scottish Banks and Scottish 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 Scottish Branch may be subject to winding-up or a scheme of arrangement or a restructuring plan. In certain circumstances, a Scottish Branch may also be subject to a CVA or administration.<sup>32</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 which has permission under Part 4A of FSMA to accept deposits, investment banks and investment firms is ineligible to obtain the moratorium.<sup>33</sup>

#### *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 or other authorised person.<sup>34</sup> The Insolvency Act does not (as in the case of administration and receivership) expressly state that a Scottish liquidator acts as agent of the company. A liquidator can, however, as established by case authority, be regarded as many things dependent on the particular circumstances including: an officer of the court; an agent or administrator for the creditors; and manager for the company itself. Upon the sale of the company’s assets,

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<sup>32</sup> A Relevant Clearing Member that is the Scottish 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 Scottish 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 EU member state other than Denmark or in the United Kingdom.

<sup>33</sup> See Schedule ZA1 to the Insolvency Act.

<sup>34</sup> See Section 124 of the Insolvency Act.

a liquidator is required to distribute the proceeds in accordance with the statutory scheme prescribed by the Insolvency Act and the Insolvency Rules. 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>35</sup> and
- the right to raise proceedings to have set aside and to seek restitution in respect of a gratuitous alienation<sup>36</sup> or an unfair preference to a creditor<sup>37</sup> in each case in respect of transactions agreed or executed prior to the liquidation.

In addition, a common law challenge may be made in respect of a gratuitous alienation or a fraudulent preference (the common law equivalent of the statutory unfair preference).

Scottish insolvency set-off rules are principally based in common law rather than in statute and must be pled in court proceedings.

The Scottish common law insolvency set-off rules are wide and allow an illiquid debt (a debt which is not actually due or ascertainable) to be set off against a liquid debt, a present debt to be set off against a future or contingent debt and in certain circumstances, different types of claims to be set off against each other. The Scottish common law insolvency set-off rules also allow the set-off of pre-insolvency claims and the set-off of post-insolvency claims, but pre-insolvency claims cannot be set-off against post-insolvency claims. The claims being set-off must arise between the two parties in the same capacity.

A Scottish court is likely to give effect to contractual set-off provisions to the extent that they are not inconsistent with Scottish insolvency set-off rules.

Whilst the anti-deprivation rule and the *pari passu* principle are established doctrines of English insolvency law, there is nothing comparable in Scottish jurisprudence. The rule of *pari passu* distribution is, however, enshrined in the Insolvency Act and the Insolvency Rules and does, therefore, form part of Scots insolvency law and an arrangement which results in a distribution otherwise than in accordance with Scots insolvency law should be rendered void by the Scottish courts. Scots law also recognises that a transaction may constitute a

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<sup>35</sup> See Sections 127 and 129 of the Insolvency Act. Section 127 avoids the disposition of company assets. The liquidator can seek restitution of those assets. 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>36</sup> *Id.* at Section 242.

<sup>37</sup> *Id.* at Section 243.

"fraud on the bankruptcy laws" although such challenges are rarely made in the Scottish courts, with the main challenges being made via the statutory gratuitous alienation and unfair preference provisions.

### *Administration*

A Relevant Clearing Member may also be placed into administration under Schedule B1 to the Insolvency Act, by either an application to a Scottish court or an out of court appointment by, amongst others, the Relevant Clearing Member's board of directors, which appointment takes effect when it is lodged with a Scottish court.<sup>38</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 (without first being in administration), or to realise the company's assets to make a distribution to one or more secured or preferential creditors.<sup>39</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 right to seek restitution in respect of dispositions of company assets made after the commencement of the administration.

### *Bank Insolvency*

The bank insolvency regime was introduced as a special procedure for the winding-up of certain "banks".<sup>40</sup> For purposes of this Memorandum, the term "bank" refers to a Relevant Clearing Member that: (i) is a Scottish 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>41</sup> The purpose of a bank liquidation proceeding is to ensure 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>42</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>43</sup> The relevant details of the bank

<sup>38</sup> A winding-up/liquidation procedure may follow the completion of an administration procedure.

<sup>39</sup> See paras. 3(1)(a)-(c) of Schedule B1 to the Insolvency Act.

<sup>40</sup> See Part 2 of the BA 2009.

<sup>41</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.

<sup>42</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>43</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).

liquidation process are set out in the Bank Insolvency (Scotland) Rules 2009 (SI 2009/351) (“**Bank Insolvency Rules**”), which generally follow the process in the Insolvency (Scotland) Rules 1986, except as needed to give effect to the rapid compensation of eligible depositors.<sup>44</sup>

### *Bank Administration*

A Relevant Clearing Member that is a bank may also be subject to bank administration.<sup>45</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>46</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>47</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>48</sup> The relevant details of the bank administration process are set out in the Bank Administration (Scotland) Rules 2009 (SI 2009/350) (“**Bank Administration Rules**”), which generally follow the process in the Insolvency (Scotland) Rules 1986, except as needed to give effect to the purpose of bank administration.<sup>49</sup> Once the bank administration has achieved its 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>50</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.

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<sup>44</sup> Note that the Bank Insolvency Rules are modelled on the Insolvency Rules (Scotland) 1986 rather than the Insolvency Rules.

<sup>45</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>46</sup> *Id.* at Section 136(2).

<sup>47</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>48</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>49</sup> There are some notable differences between the Bank Administration process and the administration process under Schedule B1 to the Insolvency Act applicable to an ordinary (non bank) company– for example, certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>50</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).

A court order appointing a building society liquidator is the only means of starting a building society liquidation.<sup>51</sup> Applications for such orders may only be made by the BoE or the PRA where certain grounds and conditions are met.<sup>52</sup> The relevant details of the building society liquidation process are set out in the Building Society Insolvency (Scotland) Rules 2010 (SI 2010/2584) (“**BS Insolvency Rules**”), which generally follow the process in the Insolvency (Scotland) Rules 1986, except as needed to give effect to the rapid compensation of eligible depositors.<sup>53</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>54</sup> Applications for such orders may only be made by the BoE where certain grounds and conditions are met.<sup>55</sup> The relevant details of the building society administration process are set out in the Building Society Special Administration (Scotland) Rules 2010 (SI 2010/806) (“**BS Administration Rules**”), which generally follow the process in the Insolvency (Scotland) Rules 1986, except as needed to give effect to the purpose of building society administration.<sup>56</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 will continue in a similar way to the standard administration procedure 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>57</sup> For purposes of this Memorandum, the term “investment bank” refers to a Relevant Clearing Member that: (i) is a Scottish 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

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<sup>51</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>52</sup> See, e.g., Sections 7, 95(1) and 96 of the BA 2009, as modified by the BS Order.

<sup>53</sup> Note that the BS Insolvency Rules are modelled on the Insolvency (Scotland) Rules 1986. There are some notable differences between ordinary liquidation and building society liquidation – for example, the mandatory establishment of a liquidation committee and certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>54</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>55</sup> See Section 143 of the BA 2009, as modified by the BS Order. PRA consent is also required under Section 362A of FSMA.

<sup>56</sup> There are some notable differences between the BS Administration process and the administration process under Schedule B1 to the Insolvency Act – for example, certain creditor preferences – which do not affect the analysis or conclusions in this Memorandum.

<sup>57</sup> See Part VII of the BA 2009 and the Investment Bank Special Administration Regulations 2011, SI 2011/245 (“**IB Regulations**”).

investments as principal; and (iii) holds client assets.<sup>58</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>59</sup> Applications may only be made where certain grounds are met.<sup>60</sup> The relevant details of the investment bank special administration process are set out in the IB Regulations and the Investment Bank Special Administration (Scotland) Rules 2011 (SI 2011/2262) (“**IB Rules**”). Unlike the Bank Administration Rules and the BS Administration Rules, the IB Rules sets out the applicable rules in full rather than cross-referring to and modifying the Insolvency (Scotland) Rules 1986. However, there are still substantial parallels between the investment bank special administration process and the standard administration process under Schedule B1 to the Insolvency Act.<sup>61</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>62</sup> As relevant here, the SRR applies to a Relevant Clearing Member that is a Scottish Bank, a Scottish Building Society or a Scottish 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>63</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.

<sup>58</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>59</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>60</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>61</sup> There are some notable differences between the investment bank special administration rule framework and Schedule B1 to 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>62</sup> For a description of the preconditions that must be met for triggering the SRR, see Section 7 of the BA 2009.

<sup>63</sup> For a more detailed discussion of these powers, and available exemptions, see Section 5.2.3 of this Memorandum, *infra*.

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 which has permission under Part 4A of FSMA to accept deposits, or that is an investment bank or an investment firm.<sup>64</sup>

#### *Company Voluntary Arrangement*

A company voluntary arrangement (“**CVA**”) is available to a Relevant Clearing Member that is a Scottish company, that is incorporated in an EEA member state, is not incorporated in an EEA member state but has its centre of main interest in an EU member state (other than Denmark), has its centre of main interest in the UK or has its centre of main interest in an EU member state and an establishment in the UK.<sup>65</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>66</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>67</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>68</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 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>69</sup> A scheme of arrangement can be used by a Scottish/UK company and could also 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.

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<sup>64</sup> See Schedule ZA1 to the Insolvency Act.

<sup>65</sup> See Section 1(4) of the Insolvency Act and EU Regulation (2015/848) on insolvency proceedings (as that Regulation has effect in the law of the EU).

<sup>66</sup> See Part 1 of the Insolvency Act.

<sup>67</sup> See Sections 1(1), (3) of the Insolvency Act.

<sup>68</sup> *Id.* at Section 5(2)(b).

<sup>69</sup> See Sections 895-899 of the CA 2006.



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>70</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 or 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>71</sup>

### *Receivership*

Receivership is a procedure applicable to a Relevant Clearing Member which the Court of Session has jurisdiction to wind up or in respect of which a court of a member state of the EU has under the EU Regulation (2015/848) on insolvency proceedings (as that Regulation has effect in the law of the EU) jurisdiction to open insolvency proceedings.<sup>72</sup> It is a process by which certain secured creditors of a company, who hold a floating charge over all or any part of the company's property, are able to appoint a receiver to manage and sell the assets subject to that floating charge to satisfy the debt owed.

The use of receivership where the floating charge is over the whole or substantially the whole of a company's assets 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>73</sup> Where receivership applies, it does not prevent 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

<sup>70</sup> See Sections 901A – 901L of the CA 2006

<sup>71</sup> *Id.* at Section 901H(5).

<sup>72</sup> See Section 51(1) of the Insolvency Act.

<sup>73</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).

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?

The Deed of Charge is stated to be governed by English law. 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>74</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>75</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>76</sup>

As a matter of English law, we understand in terms of the England and Wales Memorandum that the security interests under the Deed of Charge in the Charged Property will be validly created by a Relevant Clearing Member in favour of LCH and will be effective in the context of Insolvency Proceedings of a Relevant Clearing Member.

On the basis that the Charged Property is located in England and the Deed of Charge is governed by English law the charge over the Charged Property will be recognised by the Scottish courts.

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, as a matter of Scots law, 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>77</sup> We understand that the “relevant account” (as defined in the FCA Regulations) is maintained in England and, accordingly, all issues relating to proprietary

<sup>74</sup> See Clause 2 of the Deed of Charge.

<sup>75</sup> *Id* at Clause 3(2) (referencing sections 1.1.2a and 1.1.3 of Procedures Section 4 (*Collateral*)).

<sup>76</sup> *Id.* at Clause 3(1).

<sup>77</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*.

effects, security perfection requirements, effectiveness of security against third parties, and realisation procedures of the Charged Property, are matters of English law.

It is also our view that, as a matter of Scots law, 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>78</sup> Under the SF Regulations any realisable assets provided under a charge for the purpose of securing rights and obligations potentially arising in connection with a system are “collateral security”.<sup>79</sup> Under the SF Regulations<sup>80</sup> it is the domestic law of the country or territory, or the law of the part of the country or territory, where the register, account or centralised deposit system is maintained which governs the rights of a holder of collateral security. In our view, English law is the applicable law, and, accordingly, whether or not the Charged Property qualifies as “collateral security” is a matter for English law.

We also believe that, as a matter of Scots law, the Deed of Charge constitutes a “market charge” under Part VII (as defined below) 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>81</sup>

Based on the foregoing, and with reference to the England and Wales Memorandum on matters of English law, 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

<sup>78</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>79</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>80</sup> See regulation 23 of the SF Regulations.

<sup>81</sup> For a more detailed discussion on the definition of “market charge” and “market contract”, see Section 5.2.3 of this Memorandum, *infra*.

answer is affirmative, please identify those specific Insolvency Proceedings and/or Reorganisation

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 a Scottish 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>82</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 a Scottish 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>83</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) (Scotland) 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

<sup>82</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.

<sup>83</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.*

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 set off rules applicable on insolvency. It is therefore our view that Section 159(1) of Part VII also expressly displaces (pending completion of default proceedings) the application of the Scottish common law insolvency set-off rules to market contracts, which remain enforceable in accordance with their terms in the event of a 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>84</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) (Scotland) 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 section, we believe that Section 159 also expressly displaces (pending completion of default proceedings) the application of the Scottish common law insolvency set-off rules 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 subsequently to the property being provided as margin or as default fund contribution.<sup>85</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 contribution.

#### Limitations on Insolvency Practitioners and Scottish Courts

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<sup>84</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".

<sup>85</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.

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 Scottish 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) (Scotland) 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 Scottish courts. For example, the provision of the Insolvency Act granting the court's powers to order rescission of contracts does not apply in respect of market contracts or any contract(s) effected by LCH for purposes of realising margin property.<sup>86</sup>

In addition, Section 165 of Part VII provides that no decree 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 a gratuitous alienation or an unfair preference or other Scots law equivalent.<sup>87</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>88</sup>

Finally, all net sums certified by LCH following the completion of its default proceedings may be claimed in Scottish insolvency proceedings and can be taken into account for set-off purposes.<sup>89</sup> This provision ensures that no officeholder or Scottish 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>90</sup> 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>91</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

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<sup>86</sup> See Section 164 of Part VII.

<sup>87</sup> See Section 165(2), (3) of Part VII.

<sup>88</sup> See Section 165(4) and (5) of Part VII.

<sup>89</sup> See Section 163 of Part VII.

<sup>90</sup> See Section 173(1)(b) of Part VII.

<sup>91</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.

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 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. 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>92</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 a Scottish 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 “designated system” under the Settlement Finality Directive.<sup>93</sup> The Bank of England has duly recognised LCH as a designated system for these purposes.<sup>94</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 (both as defined in the SF Regulations) and would, in our view, include the Relevant Clearing Members.<sup>95</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

<sup>92</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.

<sup>93</sup> See Article 17(4) of EMIR.

<sup>94</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>95</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).

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 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 the 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’s 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 charge)...for the purpose of securing rights and obligations potentially arising in connection with a [designated] system”.<sup>96</sup>

#### Limitations on Insolvency Practitioners and Scottish Courts

The SF Regulations provide that the powers of, or any rule of law permitting, an Scottish insolvency official or a Scottish court (a) to disclaim onerous property or to rescind contracts do not apply to, *inter alia*, any contract for the purpose of realising collateral security; and (b) to avoid prior transactions and certain property dispositions, do not apply to, *inter alia*: (i) the provision of collateral security; (ii) any contracts for the purpose of realising collateral security or any disposition of property in pursuance of such a contract; and (iii) any disposition of property in accordance with a designated system’s rules relating to the application of collateral security.

<sup>96</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”.



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 that any net sum established by a designated system following completion of its default arrangements can be claimed in relevant insolvency proceedings. Accordingly, neither an insolvency practitioner nor a Scottish 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.

### *The FCA Regulations*

The FCA Regulations implement the EU Financial Collateral Directive<sup>97</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 a Scottish insolvency official or by an order of a Scottish 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 persons.<sup>98</sup> An SFCA refers to an arrangement whereby the collateral-provider grants a security interest over the relevant "financial collateral"<sup>99</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>100</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

<sup>97</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.

<sup>98</sup> See Regulation 3(1) of the FCA Regulations.

<sup>99</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>100</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.

financial obligations owed to the collateral-taker; (iii) a security interest arises to secure such obligations; and (iv) the financial collateral is delivered so as to be in the “possession” or “control” of the collateral-taker.<sup>101</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.

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 in the name 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 limited to the right to substitute financial collateral of similar (or greater) value or to withdraw excess financial collateral.<sup>102</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>103</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>104</sup>

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

<sup>101</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).

<sup>102</sup> Regulation 3(2) of the FCA Regulations.

<sup>103</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>104</sup> *Private Equity Insurance Group SIA 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.

basis”.<sup>105</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>106</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>107</sup> It is therefore our view that the conditions for creating a TTCA are satisfied.

Based on the foregoing, it is our view that Regulation 20(s) constitutes a TTCA, and the Default Provisions are an “arrangement” that “forms part” of such TTCA. Accordingly, the Default Provisions benefit from the protections set out below against the ordinary UK law of insolvency. In relation to the Deed of Charge constituting an SFCA see the England and Wales Memorandum.

#### 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 collateral-taker under the arrangement is subject to winding up proceedings or reorganisation measures.<sup>108</sup> The FCA Regulations also expressly state that any rule of law in Scotland with the same or similar effect to English statutory insolvency set-off rules shall not apply to a close-out netting provision.<sup>109</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:*

<sup>105</sup> See Regulation 20(s)(i)-(iii) of the Rulebook.

<sup>106</sup> See note 99, *supra*.

<sup>107</sup> See Regulation 20(u) of the Rulebook.

<sup>108</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>109</sup> See Regulation 12(4) of the FCA Regulations.

- (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>110</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 Scottish 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>111</sup> Nor do the provisions of the Insolvency Act relating to avoidance of property dispositions and avoidance of share transfers apply in respect of any disposition or transfer arising under a financial collateral arrangement or a close-out netting provision.<sup>112</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>113</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

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<sup>110</sup> See Regulation 3(1) of the FCA Regulations.

<sup>111</sup> See Regulation 8 of the FCA Regulations.

<sup>112</sup> See Regulation 10 of the FCA Regulations.

<sup>113</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 a Scottish company, the creditor must ordinarily register the charge with Companies House under the CA 2006.

below two such powers –the property transfer power and the bail-in power – and certain other relevant provisions of the SRR.<sup>114</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>115</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, a number of safeguards have been put in place.<sup>116</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>117</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 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>118</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, obligations of an SRR Entity.<sup>119</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

<sup>114</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>115</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>116</sup> See The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (“**Safeguards Order**”).

<sup>117</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”.

<sup>118</sup> Article 5 of the Safeguards Order.

<sup>119</sup> See Section 12A of the BA 2009.

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>120</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>121</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>122</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>123</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, netting arrangement or title-transfer collateral arrangement.<sup>124</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>125</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 a “qualifying contract” with an entity in resolution.<sup>126</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>127</sup> LCH is both a recognised central counterparty for purposes of FSMA as well as the

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<sup>120</sup> *Id.* at Section 48B(4)(b).

<sup>121</sup> *Id.* at Section 48B(8)(e), (ea).

<sup>122</sup> *Id.* at Section 48B(8)(b).

<sup>123</sup> See The Banking Act 2009 (Restriction of Special Bail-In Provision, etc.) Order 2014 (“**Bail-In Order**”).

<sup>124</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>125</sup> *Id.* at Article 4(6).

<sup>126</sup> See Sections 70A-C of the BA 2009.

<sup>127</sup> *Id.* at Section 70D.

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>128</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>129</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, provisions of the Insolvency Act permit a Scottish court to set aside transactions (or grant such other redress, including restoration of the property, as may be appropriate) entered into by an insolvent party:

- *Gratuitous Alienations.* An insolvency practitioner<sup>130</sup> or, in the case of a liquidation, a creditor of the Relevant Clearing Member, may ask a Scottish court to set aside a transfer of any part of the Relevant Clearing Member's property or the discharge or renunciation of any claim or right of a Relevant Clearing Member (an "**Alienation**") made within two years (or 5 years where the alienation favours a connected person) of either the commencement of the winding up of the Relevant Clearing Member or of the Relevant Clearing Member entering into administration and the court shall grant decree unless it is established that:
  - (a) immediately, or at any other time after the Alienation, the Relevant Clearing Member's assets were greater than its liabilities; or
  - (b) the Alienation was made for adequate consideration<sup>131</sup>.
- *Unfair Preferences.* An insolvency practitioner or, in the case of liquidation, a creditor of the Relevant Clearing Member, may also request a Scottish court to set aside a transaction that

<sup>128</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>129</sup> *Id.* at Section 75.

<sup>130</sup> Such a transfer may be challenged by a liquidator or creditor (in a winding up) or an administrator (in an administration). Note that in relation to a Scottish Bank, the terms "**liquidator**" and "**administrator**" include a bank liquidator and bank administrator respectively; and, in relation to a Scottish Investment Bank, these terms include any individual(s) appointed as administrator pursuant to the investment bank special administration procedure, the special administration (bank insolvency) procedure or the special administration (bank administration) procedure.

<sup>131</sup> See Section 242 of the Insolvency Act.

has the effect of creating a preference in favour of a creditor to the prejudice of the general body of creditors of the Relevant Clearing Member where within 6 months of that transaction a winding up of the Relevant Clearing Member commences or the Relevant Clearing Member enters administration, unless it was:

- (a) a transaction in the ordinary course of trade or business; or
- (b) a payment in cash for a debt which when it was paid had become payable, and the transaction was not collusive with the purpose of prejudicing the general body of creditors of the Relevant Clearing Member; or
- (c) a transaction whereby the Relevant Clearing Member and the counterparty undertook reciprocal obligations (whether the performance by the parties of their respective obligations occurs at the same time or at different times) and the transaction was not collusive as above.<sup>132</sup>

In addition to the statutory remedies under the Insolvency Act, Scots law common law remedies of gratuitous alienation and fraudulent preference (the common law equivalent of the statutory unfair preference) permit a Scottish court to set aside a transaction. The time limits that apply to the regulatory equivalents do not apply to the common law remedies, but additional equivalent requirements apply.

If a gratuitous alienation or an unfair preference is successfully challenged, the Scottish court will make such decree (order) of reduction (avoiding the transaction) or for restoration of property or other redress as may be appropriate.

The provisions of the Insolvency Act set out above that permit a Scottish court to avoid (or grant such other redress, including restoration of the property, as may be appropriate) 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?

On insolvency common law, rather than statutory, set-off rules largely apply, and must be pled in court proceedings.

The Scottish insolvency set-off rules are wide and allow an illiquid debt (a debt which is not actually due or ascertainable) to be set off against a liquid debt, a present debt to be set off against a future or contingent debt and in certain circumstances, different types of claims to be set off against each other. The Scottish insolvency

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<sup>132</sup>

*Id* at Section 243.



set-off rules also allow the set-off of pre-insolvency claims and the set-off of post-insolvency claims, but pre-insolvency claims cannot be set-off against post-insolvency claims. The claims being set-off must arise between the two parties in the same capacity.

A Scottish court is likely to give effect to contractual set-off provisions to the extent that they are not inconsistent with Scottish insolvency set-off rules.

In addition, Regulation 12(1) of the FCA Regulations provides that a close-out netting provision constituting a term of a financial collateral arrangement, or an arrangement of which a financial collateral arrangement forms part, shall take effect in accordance with its terms notwithstanding that one of the parties to the relevant financial collateral arrangement is subject to "winding-up proceedings" or "reorganisation measures" (both as defined in the FCA Regulations). We mention Regulation 12 of the FCA Regulations because, technically, it is an example of a piece of netting legislation implemented in this jurisdiction. Close-out netting in accordance with a close-out netting provision under Regulation 12(1) of the FCA Regulations would prevail over the application of the Scottish common law insolvency rules in the event of liquidation or administration proceedings relating to a Relevant Clearing Member.

In our view, the Default Rules (in particular, Rules 3, 6, 7 and 8) would qualify as a close-out netting provision constituting a term of which a financial collateral arrangement forms part under Regulation 12(1) of the FCA Regulations, the relevant "financial collateral arrangement" for these purposes being a "title transfer financial collateral arrangement" in respect of "financial collateral" in the form of "cash" (as each term is defined in the FCA Regulations). The arrangements for the transfer of Collateral in the form of cash between (i) LCH and each Relevant Clearing Member in respect of their respective variation margin obligations and (ii) by each Relevant Clearing Member to LCH in respect of its initial margin obligations constitute the relevant title transfer financial collateral arrangement.

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 therein.

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 Scots 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>133</sup> Plainly, therefore, the term includes the

<sup>133</sup> See Section 155A(2)(a)-(b) of Part VII.

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>134</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*,<sup>135</sup> 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>136</sup> The term also expressly includes “transfers of property made in accordance with Article 48(7) of [EMIR]”.<sup>137</sup> We believe this term should 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>138</sup>

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 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>139</sup>

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<sup>134</sup> See Section 189A of Part VII.

<sup>135</sup> See Section 155A(4)(b)(i)-(iii) of Part VII.

<sup>136</sup> See Section 155A(4)(b)(i)-(iii) of Part VII.

<sup>137</sup> See 155A(4)(a) of Part VII.

<sup>138</sup> For the reasons set out in Section 5.2.3, *supra*, we believe that Section 159 of Part VII also expressly displaces (pending completion of the default proceedings) the application of the Scottish common law insolvency rules to the “transfer” of “qualifying collateral arrangements” and “qualifying property transfers” during the pendency of a CCP’s default proceedings.

<sup>139</sup> See Section 164 of Part VII.

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 relevant here, the term “qualifying property transfer” expressly includes “transfers of property made in accordance with Article 48(7) of [EMIR]”.<sup>140</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 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.

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<sup>140</sup>

See Section 155A(4)(a) of Part VII.

- 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>141</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>142</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>143</sup> In addition, the SF Regulations provide that the powers of a Scottish insolvency official or a Scottish 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>144</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 LCH’s default management of an insolvent Relevant Clearing Member, including the Default Provisions.<sup>145</sup>

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<sup>141</sup> See Regulation 2(1) of the SF Regulations.

<sup>142</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>143</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>144</sup> See Regulation 20 of the SF Regulations.

<sup>145</sup> See Regulation 14 of the SF Regulations.

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 this Memorandum, *supra*.

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For and on behalf of Brodies LLP