MARGIN CALLS DURING GLOBAL CRISES

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An overview of the legal issues that may arise from margin calls triggered during periods of market turmoil, such as the crises prompted by the COVID-19 pandemic, the war in Ukraine, energy-price movements and recent international and UK domestic politics.

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SCOPE OF THIS NOTE

The term "margin call" describes a situation where one party to a financial transaction requires its counterparty to provide greater collateral to protect it against the risk of the counterparty defaulting. The transaction in question may be as simple as a loan contract where a fall in the value of assets used to secure the obligations of the borrower entitles the lender to require the borrower to post additional security. Very often the transaction will be some form of derivative linked to movements in, say, stock indices or foreign exchange rates; here the risk of a party defaulting, or the gravity of the situation if they do default, involves a complex analysis of the underlying risk. Derivative transactions of this type will often be documented under the ISDA Master Agreement, which contains detailed provisions relating to margin calls. However, this is not necessarily the case and where the derivative takes the form of a spread-bet or a currency derivative, to which the counterparty is an individual, the margin call provision will often be set out in standard customer terms and conditions.

The market dislocations caused by the COVID-19 pandemic are understood to have triggered margin calls on a scale not seen since the financial crisis of 2008. In addition, sharp movements in commodities prices and turbulent international and domestic politics have continued to cause intense volatility. Banks, investment firms and their customers have been faced with sudden and invidious decisions as the risk associated with open trades has suddenly ballooned or the value of collateral associated with lending has collapsed.

This note looks at a number of contexts in which margin calls are likely to arise and at various cases, many of which arose out of the 2008 crisis, in which difficult legal issues associated with such calls have been considered.

MARGIN CALLS UNDER THE ISDA MASTER AGREEMENT

Regulatory margin obligations

In response to the challenges experienced in 2008, a requirement to clear certain classes of over-the-counter (OTC) derivatives through a central clearing counterparty (CCP) was introduced by the Regulation on OTC derivative transactions, central counterparties and trade repositories (648/2012) (European Market Infrastructure Regulation or *EMIR*). Derivatives not subject to mandatory clearing through a CCP became subject to new margin rules under which in-scope counterparties are required to exchange two forms of collateral, initial margin (IM) and variation margin (VM).

The *retained EU law version* of EMIR (UK EMIR) has applied in the UK from the end of the Brexit transition period (11.00 pm (UK time) on 31 December 2020 or IP completion day). For the purposes of this note, unless stated otherwise, references to EMIR include UK EMIR.

IM is calculated at the outset and is designed to protect the counterparties against potential future losses. VM is calculated on an ongoing basis by reference to the "aggregate net value" on a mark-to-market basis of the counterparties' positions under either one transaction or under a group of transactions known as a "netting set". VM is thus a dynamic figure and protects against market movements during the lifetime of the derivative. Increases in the amount of VM required by a counterparty will give rise to a margin call.

The exact scope and application of the EMIR requirements depends upon the type of counterparty and the type of derivative. Physically settled FX forwards, for example, are only subject to VM. Counterparties themselves are divided into "Financial counterparties" (including, banks, investment firms, insurers and alternative investment funds (AIFs)) and "Non-Financial Counterparties" (essentially everyone else), and these categories are themselves divided into "FC- "/"FC+" and "NFC-"/"NFC+" by reference to the volume of derivative trading activity they undertake. The requirement to exchange VM has now been phased-in for all counterparties, as has the requirement to exchange IM, as of 1September 2022.

For more information on EMIR's requirements for uncleared OTC derivatives, see *Practice notes, EMIR: risk mitigation requirements for uncleared OTC derivatives* and *UK EMIR: Title II: clearing, reporting and risk mitigation of OTC derivatives (Articles 4-13a).*

ISDA credit support documents

In 2016, the *International Swaps and Derivatives Association* (ISDA) introduced a new suite of credit support documents to provide a mechanism for the exchange of margin for derivatives documented under the ISDA Master Agreement. These include a Credit Support Annex for Variation Margin (the 2016 VM CSA) and a "Phase One" Credit Support Deed for Initial Margin (2016 IM CSD). The latter was updated in 2018 (2018 IM CSD). Similar documents have been put in place under New York law and for Islamic hedging.

The 2016 and 2018 documents do not apply retrospectively to existing trades so the 1995 ISDA Credit Support Annex (1995 CSA) is also still widely in use. A key difference is that the 1995 CSA employed a title transfer arrangement for all collateral, whilst under the 2016 and 2018 documents collateral in respect of VM is subject to title transfer while collateral in respect of IM is subject to a security arrangement.

Under the 2016 VM CSA, the "Valuation Agent" is required to calculate on each "Valuation Date" (in practice each business day) the amount that would be payable by one counterparty to the other pursuant to section 6(e)(ii)(1) of the ISDA Master Agreement (2002 version), if the transaction were terminated on a no-fault basis. This amount is defined as the "Exposure". If the amount calculated exceeds the amount of collateral already posted by the relevant counterparty, then it may be required to post additional collateral (Delivery Amount) on (effectively) a same day basis. Only certain types of assets, referred to as "Eligible Credit Support (VM)", may be posted by way of collateral, and these assets may themselves be subject to "Valuation Percentage" haircuts to reflect their perceived riskiness along with "FX Haircut Percentages" where they are denominated in a currency other than that in which the Exposure is calculated. All calculations, valuations and determinations performed under the 2016 VM CSA are subject to an overriding obligation under paragraph 9(b) that they be made "in good faith and in a commercially reasonable manner".

In May 2021, ISDA expanded its Clause Library to provide standard drafting clauses for use in conjunction with its credit support documents in cases where there is no need for customisation.

For a detailed overview of the 2016 VM CSA and the 2018 IM CSD, see *Practice note, Understanding ISDA®'s English law credit support documents for regulatory margining; the 2016 VM CSA and 2018 IM CSD*.

Potential for disputes

Disputes are most likely to arise as to the calculation by the Valuation Agent of either the Delivery Amount (that is, the amount of the margin call) or the value of the Eligible Credit Support VM (that is, the collateral posted). Paragraph 4 of the 2016 VM CSA (Dispute Resolution) provides a mechanism that must be employed by the counterparties in the event of such dispute. The timeframes involved are tight:

- The dispute must be notified by no later than the close of business on the business day following the relevant margin call or transfer.
- Any undisputed amount of collateral must be transferred.
- The parties must consult.

- If the parties cannot resolve the dispute the Valuation Agent must recalculate the Exposure using a specified approach.
- The Valuation Agent must notify the parties of the recalculated amount.
- The relevant counterparty is obliged to make any transfer so calculated.

This entire process is likely to last no more than two or three days. For as long as the Dispute Resolution process is being followed, a failure to post collateral beyond the undisputed amount will not constitute an Event of Default, but if the relevant counterparty fails to transfer collateral after the process is complete, this will constitute a "Failure to Pay or Deliver" Event of Default under section 5(a)(i) of the ISDA Master Agreement (2002 version) giving the non-defaulting party the right to terminate.

The procedures outlined above can operate at a blistering speed in a turbulent market. Financial institutions facing Events of Default caused by unanswered margin calls must make very rapid decisions as to whether to exercise termination provisions or, instead, wait in the hope that market conditions will improve. An institution's capacity to wait-and-see may be severely constrained by regulatory capital issues where huge amounts of risk have suddenly been added to its balance sheet.

Most litigation in the English courts to-date has been directed at picking up the pieces after a missed margin call has led to early termination, rather than focusing on the margin call process itself. However, the approach to the calculation of a margin call amount under the 1995 CSA was considered by Mr Justice Cooke in *Deutsche Bank AG v Sebastian Holdings Inc [2013] EWHC 3463 (Comm)*.

The case arose from the close out by Deutsche Bank of a large number of FX trades documented under an ISDA Master Agreement (1992 version) following the defendant's failure to meet in full a margin call of some US$500m. The FX trades in question included trades referred to in the case as "Exotic Derivative Transactions" (EDTs) and "Other Complex Transactions" (OCTs). The defendants advanced a large number of defences to the bank's claim to recover the close out amount, including an argument that the margin calls were ineffective because the bank's systems did not provide a proper method for the calculation of Exposure in relation to either EDTs or OCTs. The Judge held that, in the circumstances, the requirement of good faith and commercial reasonableness in clause 9(b) of the CSA had not been met, observing that where it was impossible for the bank to effect proper margin calculations in accordance with the CSA, the "commercially reasonable course" would have been to "produce figures by reference to the best available information and to inform the client of the difficulty with a view to sitting down and negotiating sensible margin figures" [1201]. However, he rejected an argument that these deficiencies rendered the margin call invalid, holding that the requirement of good faith and commercial reasonableness in paragraph 9(b) "cannot be read as a condition precedent to the validity of a margin call" and that "to the extent that there is any breach, damages would follow, if any were suffered, which in most situations will be unlikely" [1153]. For more information on the case, see *Legal update, FX prime brokerage: Failure to calculate margin accurately not breach of contract (High Court).*

Once made, margin calls remain effective and are not, absent a clear indication to the contrary, superseded by later margin calls (whether in lesser or greater amounts) on the same account. In *Goldman Sachs International v Videocon Global Ltd [2013] EWHC 2843 (Comm)*, Mr Justice Robin Knowles rejected an argument that a "Notice of Potential Event of Default" and subsequent notice designating an "Early Termination Date" were ineffective because the (unpaid) margin call on which they were based had been followed by further margin calls on successive dates in different amounts. The initial margin call remained valid and needed to be satisfied. For more information on the case, see *Legal update, Late but still effective (confirmed): notice under section 6(d) of the ISDA Master Agreement (Court of Appeal).*

MARGIN CALLS UNDER NON-ISDA TERMS

Despite the new margin requirements introduced by *EMIR*, a huge number of transactions giving rise to potential margin calls remain outside its scope and a number of cases in the fields of spread betting, options trading and leveraged investment in structured products have examined the validity and effect of margin calls outside the ISDA context.

Construction of margin call provisions

The validity and calculation of a margin call in such context is of course a matter of construing the relevant contractual provisions. Such provisions will be construed contra proferentem. A good example of this may be seen in *Spreadex Ltd v Battu [2005] EWCA Civ 855*, in which the claimant spread betting company sought to rely on the following provision in relation to margin required of customers placing bets through their accounts with it:

> "When dealing with us, you are entering into transactions which, unless otherwise agreed, will usually require a deposit to be paid either at the time when the bet is opened or at any time thereafter. You may also be required to make additional deposit payments on new or existing bets; and margin payments sufficient to meet the amount which, when a movement adverse to your bet has taken place, you would lose on the bet, if it were based on the current quotation for the index concerned."

This wording appears to have been an attempt to provide for something equivalent to IM and VM, albeit in more layman's terms. The question arose as to whether these two forms of security were cumulative (as Spreadex contended) or overlapping (as the customer contended) and, therefore, whether Spreadex had been entitled to close out the customer's account when it had failed to meet a margin call calculated on the basis that the sums were cumulative. At first instance, the Court found in favour of Spreadex but this was reversed on appeal. Rix LJ (with whom Neuberger and Mummery LJJ agreed) observed that either interpretation "would make perfectly good commercial sense" [50] but that ultimately the complex system of "insulated deposits" for which Spreadex contended was at odds with contractual documents that "speak so haphazardly on the subject of deposit and margin" [69]. His Lordship added that, if there were any doubt, it would have to be resolved against Spreadex.

Spreadex's contractual terms in respect of margin received further scrutiny in *Spreadex Ltd v Sekhon [2008] EWHC 1136 (Ch)* where the issue of construction focused on the following wording as to the timing of payment:

> "25.11 Within the time limits set out below you must pay to us (i) the sum demanded or deemed to have been demanded in the margin call, PLUS OR MINUS, (ii) any sum by which the amount your account is in deficit changes between the time when the margin call is made and the time when the money is in fact paid. If you are unsure of the precise sum that is due from you at the time of payment, you should telephone us and ask for the updated figure."

The two questions that arose were, first, what constitutes a margin call in order to trigger the payment obligation and, second, what happens if, during the period permitted for payment, market fluctuations meant that, at least temporarily, the deficit giving rise to the margin call disappeared? In respect of the first of these questions, Mr Justice Morgan held that surprisingly little formality was required, to the extent that it was not even necessary to specify the figure payable:

> "The minimum content of a communication which is required for that communication to qualify as a margin call is that Spreadex asks the client to pay money, whether a sum is specified or not, and the words used in the relevant context reasonably convey to a reasonable recipient the fact that Spreadex is asking for margin call, as that phrase is understood in the Agreement. It is not necessary for Spreadex to say in terms that the request for payment of money is a margin call if that fact would be understood by a reasonable recipient of the communication" [88].

As to the second question, he held that any temporary evaporation of a deficit would be irrelevant if a deficit justifying a margin call existed at the end of the period allowed for payment [98].

If there is a point of general application to take out of these cases, it is perhaps that clear terms are needed to set out the rights and obligations of the parties in a margin call situation given the fast moving nature of such a situation and the potentially dire consequences to the customer of failing to meet a margin call. Any lack of clarity in such terms is likely to rebound against the party relying upon them.

Regulatory and contractual protections for the customer

The provision of "margin" to "private customers" was subject to regulatory rules under the FCA's Conduct of Business rules (COB) before the implementation of the *Markets in Financial Instruments Directive (2004/39/EC)* (MiFID) through the Conduct of Business sourcebook (COBS) in November 2007. COB contained a rule at COB 7.10.5R that a firm providing "margin" in the context of "designated investment business" (such as spread betting, options trading, or lending for the purchase of investments) must close out a private customer's open position if it failed to meet a margin call for five business days following a margin call. A claim based on a breach of this rule succeeded in *Spreadex v Sekhon*, albeit that resulting damages were reduced by 85% on grounds of contributory negligence.

The rule in COB 7.10.5R was not carried over into COBS and, in *IG Index Ltd v Ehrentreu [2015] EWHC 3390 (QB)*, Mr Justice Supperstone rejected an argument that an equivalent requirement could be implied into the high level requirement on firms in COBS 2.1.1R to "act honestly, fairly and professionally in accordance with the best interests of its client". This judgment was upheld on appeal (*Ehrentreu v IG Index Ltd [2018] EWCA (Civ) 79*), but this aspect of the decision at first instance was not challenged.

Recent amendments to the COBS sourcebook at *COBS 22.5*, "Restrictions on the retail marketing, distribution and sale of contracts for differences and similar speculative investments", have, however, introduced margin requirements for retail clients trading in "restricted speculative investments", namely leveraged contracts for differences, leveraged spread bets, leveraged rolling spot forex contracts and certain restricted options. COBS 22.5.11R obliges firms to require retail clients to post margin of specified amounts in order to open positions; the amount varies depending on the type of underlying asset, ranging from 3.33% of an exposure where the underlying asset is a major foreign exchange pair to 20% of the exposure when the underlying asset is a share or an asset not otherwise listed in the rule. COBS 22.5.13R obliges firms to close out a retail client's open positions "as soon as market conditions allow" where the client's "net equity" falls below 50% of the margin requirement. "Net equity" is defined as the sum of the retail client's net profit and loss on their open position(s) and the retail client's deposited margin. Under COBS 22.5.15R, a firm must provide to a client a clear description of how the close out level will be calculated and triggered in good time before the client opens their position and before any change to the applicable terms and conditions. Under COBS 22.5.16G, when making a margin call or closing a retail client's position firms must comply with COBS 2.1.1R (the client's best interests rule). By way of ultimate backstop, COBS 22.5.17R, "Negative balance protection", provides that a retail client's liability for all restricted speculative investments connected to their account is limited to the funds in that account. This means that a retail client cannot lose more than the funds specifically dedicated to trading in such investments. These requirements build on temporary product intervention measures introduced by the European Securities and Markets Authority (ESMA) restricting the way in which contracts for differences may be sold to retail investors (see *FCA Consultation paper: Restricting contract for difference products sold to retail clients and a discussion of other retail derivative products (7 December 2018) (CP18/38)* and *FCA Policy statement: Restricting contract for difference products sold to retail clients (1 July 2019)* (PS19/18)).

In addition to these provisions, a disclosure rule of general application may be found at COBS14.3A.5, which requires investment firms to provide to clients or potential clients "a general description of the nature and risks of financial instruments" to include, "where relevant to the specific type of instrument concerned and the status and level of knowledge of the client", "any margin requirements or similar obligations, applicable to instruments of that type." Importantly, this requirement extends to all types of "client", albeit that a right of action for damages arising from its breach extends only to "private persons" within the meaning of the *Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)*. The extent to which corresponding tortious duties of care arise must be considered on the facts of each case.

Damages and causation

Finally, difficult questions relating to damages and causation have been considered in cases where margin calls have been raised in breach of contract or valid margin calls have not been met.

In *Spreadex Ltd v Battu*, for reasons discussed above, the Court of Appeal found that Spreadex had not been entitled to levy a particular margin call and had therefore closed out the customer's trades in breach of contract. The customer counterclaimed for damages on the basis that it would have kept its positions open for several more days before closing them out at an advantageous moment. Rix LJ noted "significant difficulties" in the counterclaim, firstly that the market in which the customer was trading (the Dow Jones Index) had suffered large falls in the period in question before recovering, raising questions as to whether the customer would have been able to sustain associated losses before its portfolio recovered.

Even more difficult, perhaps, was the question as to whether the customer's claim for damages should be reduced on the grounds that it had failed to mitigate its losses after its account was closed out, by "restoring [its] positions at favourably high levels of the index so as to make [its] projected gains in any event".

The issue of mitigation was further considered in two contrasting decisions based on similar facts, namely the close-out by Credit Suisse of leveraged investment portfolios following the failure of the relevant clients to meet margin calls triggered by declines in the mark-to-market value of certain structured notes. Both customers brought claims for damages on the basis that the structured products had been purchased as a result of unsuitable investment advice and in each case the bank pleaded that the customer's failure to meet the margin call when they had the resources to do so represented a break in the chain of causation. In *Sulaiman v Credit Suisse Securities (Europe) Ltd [2013] EWHC 400 (Comm),* Mr Justice Cooke held that the customer's decision not to meet the margin call was extraneous to any failure to advise and constituted a failure to mitigate, noting "it is clear that the provision of additional collateral would appear to any sensible person as the prudent course to adopt and a deliberate failure to produce additional margin and thereby precipitate the distressed sale of all the Notes, whether capital protected or not, completely nonsensical" [211]. By contrast, in *Haider Abdullah v Credit Suisse (UK) Ltd [2017] EWHC 3016 (Comm)* Mr Justice Andrew Baker noted that "there is no rule of law that a failure to meet a margin call an investor could readily meet breaks the chain of causation or amounts to contributory negligence" [214] and that on the facts it had not been irrational or unreasonable for the claimant investors to refuse to meet a margin call and therefore allow their positions to be closed out - even in the face of advice that to do so would be "financial suicide" [243]. For more information on this case, see *Legal update, Section 138D(2) FSMA claim concerning suitability of structured product sales partially succeeds in High Court.*

CONCLUSIONS

The ability to make a margin call is an important safeguard to limit exposure in a range of financial transactions. The steps that a party may take to enforce extra margin, and the methodology of calculation, will ultimately depend on the terms of the contract. While there is a measure of uniformity under ISDA's documentation framework, there remains considerable scope for dispute over the calculation of the Delivery Amount and the value of the Eligible Credit Support VM, in particular. And beyond ISDA, there are a multitude of transactions with bespoke terms. The making of a margin call may well, in and of itself, set in train a sequence of events with terminal consequences. From the perspective of the counterparty, the decision whether to post margin, and if so, in what form, will be a critical one. At a time of fast-moving markets, this being the most likely moment for margin call triggers, these determinations will have to be made within days, if not hours. A proper understanding in advance of the extent, and limits, of a party's contractual entitlements may avoid the pitfalls of rushed or even automated decisions that do not achieve their purpose or, at worst, prove detrimental to a party's interests.