COVID-19: Margin Calls

Adrian Beltrami QC and David Simpson offer an overview of the legal issues that may arise from margin calls triggered during periods of market turmoil.

The market dislocations caused by the current coronavirus crisis are understood to have triggered margin calls on a scale not seen since the financial crisis of 2008. 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

In response to the challenges experienced in 2008, a requirement to clear certain classes of OTC derivatives through a Central Clearing Counterparty (CCP) was introduced by the European Market Infrastructure Regulation (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). 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 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 Variation Margin has now been phased in for all counterparties, but the requirement to exchange IM is still being phased in by reference to the type of counterparty and the volume of their business.

In 2016 ISDA introduced a new suite of credit support documents to provide a mechanism for the exchange of margin for derivatives documented under the English law 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 (the 2016 IM CSD). The latter was updated in 2018 (the 2018 IM CSD). Similar documents have been put in place under New York law. The 2016 and 2018 documents do not apply retrospectively to existing trades so the 1995 ISDA Credit Support Annex (the 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 Master Agreement, 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 ('the 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".

Financial institutions facing Events of Default caused by unanswered margin calls must make very rapid decisions as to whether to exercise termination provisions.

Disputes are most likely to arise as to the calculation by the Valuation Agent of either the Delivery Amount (i.e. the amount of the margin call) or the value of the Eligible Credit Support VM (i.e. 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 and 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 clause 5(a)(i) of the Master Agreement 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), a case arising from the close out by Deutsche Bank of a large number of FX trades documented under the ISDA Master Agreement 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].

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 has been followed by further margin calls on successive dates in different amounts. The initial margin call remained valid and needed to be satisfied.

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."

Recent amendments to the COBS sourcebook have introduced margin requirements for retail clients trading in "restricted speculative investments".

This wording appears to have been an attempt to provide for something equivalent to Initial and Variation Margin, 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 thus whether Spreadex had been entitled to close out the customer's account when he 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 which "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 which arose where, 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) prior to the implementation of MiFID through 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 upon 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 ([2018] EWCA (Civ) 79) but this aspect of the decision at first instance was not challenged.

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Difficult questions in relation 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.

Very recent amendments to the COBS sourcebook at COBS 22.5, "Restrictions on the distribution of certain complex investment products", 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 upon the type of underlying asset, ranging from 3.33% of an exposure where the underlying is a major foreign exchange pair to 50% of the exposure where the underlying asset is a cryptocurrency. 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. 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 upon temporary product intervention measures introduced by the European Securities and Markets Authority restricting the way in which contracts for differences may be sold to retail investors (see the FCA's Consultation Paper CP18-38 and Policy Statement 19-18).

In addition to these provisions, a disclosure rule of general application may be found at COBS14.3A.5 which sets out the requirement in Article 48 of the MiFID II Delegated Regulation that investment firms must 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 Rights of Action Regulations. The extent to which corresponding tortious duties of care arise must be considered on the facts of each case.

Damages/causation

Finally, difficult questions in relation 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 thus closed out the customer's trades in breach of contract. The customer counterclaimed for damages on the basis that he would have kept his 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 DJ 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 his 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 he had failed to mitigate his losses after his account was closed out, by "restoring his positions at favourably high levels of the index so as to make his projected gains in any event."

The issue of mitigation was further considered in two contrasting decisions based upon similar facts, namely the close-out by Credit Suisse of leverage 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 thus allow their positions to be closed out – even in the face of advice that to do so would be "financial suicide" [243].

Conclusions

The ability to make a margin call is an important safeguard to limit exposure in a range of financial transactions. The steps which a party may take to enforce extra margin, and the methodology of calculation, will ultimately depend on the terms of the contract. Whilst there is measure of uniformity under ISDA, 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 which do not achieve their purpose or, at worst, prove detrimental to a party's interests.

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