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LEGAL ANALYSIS

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The Insolvency Risk on TIFFE and on TSE: Two Different Approaches to the Insolvency Risk

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The aim of this analysis is to examine, through the description of the legal aspects of financial futures dealings, the different structures chosen by the Tokyo Financial Futures Exchange (TIFFE) and the Tokyo Stock Exchange (TSE) in relation to the distribution of the credit risk among players. The analysis highlights that the legal framework of the two Exchanges differs on some substantial points, which has some major repercussions – at least in theory – on the risk exposure of the parties dealing in financial futures.

Introduction

On TIFFE four financial futures contracts are traded: three-month Euroyen future, one-year Euroyen future, three-month Eurodollar future, US dollar–Japanese yen currency future (and option on three-month Euroyen future). On TSE three financial futures contracts are traded: 10-year Japanese government future, 20-year Japanese government future and 20-year US government future.

Broadly speaking, financial futures are traded by open outcry or by electronic matching system on a centralised and regulated exchange. Contracts are highly standardised, with trading in specific months for specific quantities of product.

On the open outcry or in the electronic system there is no opportunity of checking the credit-worthiness of counterparties. The major role of the exchange consists in eliminating the credit risk and the necessity to assess the worth or integrity of the other party to a trade.

The author will describe how differently this role is performed by TIFFE and TSE.

The Legal Framework of Financial Futures Dealings on TIFFE

TIFFE is a Japanese legal entity.¹ It has a non-profit-making purpose.²

Its shareholders are the members. The maximum number of members allowed is 350 out of which 120 can be clearing members (CMs).³ Currently there are 262 members of which 108 are CMs. CMs are banks, securities houses and futures firms. General members (GMs, members which are not CMs) are banks, securities houses, futures firms, 'tanshi' (Japanese-style brokers) and insurance companies.

The capital contribution of CMs is Yen150 million and of GMs, Yen75 million.⁴ Members can be CMs if they undertake to act as clearers.

Members who are not CMs shall enter into a clearing agreement with one (or more) CMs.⁵ Whenever a bid or an offer made by a GM is accepted, a financial futures contract shall be deemed to be made in the name of the CM designated by the said GM.⁶

TIFFE receives bids and offers exclusively from members (either GMs or CMs), but – from the legal point of view – contracts are always closed in the name of a CM, either for its own account or for a GM's account.⁷

The TIFFE automatic system matches all offers and bids received⁸ and financial futures contracts are closed between CMs.

Simultaneously TIFFE

shall be deemed to have assumed automatically all the obligations of a CM owing to another CM for whom such financial futures contract constitutes a purchase contract (the 'Buyer') in place of the Seller whereupon the Seller shall be released from such obligations, and the Seller shall owe new obligations to the Exchange, the terms of which are identical to those of the obligations assumed by the Exchange; and the Exchange shall be deemed to have assumed automatically all the obligations of the Buyer owing to the Seller under such financial futures contract in place of the Buyer whereupon the Buyer shall be released from such obligations, and the Buyer shall owe new obligations to the Exchange, the terms of which are identical to those of the obligations assumed by the Exchange.⁹

Therefore CMs do not carry the credit risk of other CMs, but TIFFE does.

However, CMs have an unlimited pro rata obligation to cover losses suffered by TIFFE as a result of a CM's default,¹⁰ should the Loss Compensation

1. Article 1 Financial Futures Trading Law no. 77, 1988 ('Law'); Article 3 Articles of Association of TIFFE ('AA').

2. Article 5 Law.

3. Article 7 AA.

4. Article 16 AA.

5. Article 11 AA.

6. Article 11 AA, Article 19 Trading and Clearing Regulations of TIFFE ('Regs').

7. Article 8 AA.

8. Articles 9 to 18 Regs.

9. Article 22 Regs, Article 104 AA.

10. Articles 120, 121 AA.

Deposit (LCD)¹¹ made by the defaulted CM and the LCDs made by all other CMs not be sufficient to cover such losses.

Brokers are legal entities licensed by the Minister of Finance to act as brokers of financial futures.¹² Currently there are 250 brokers. The brokers' role is to allow customers to deal in financial futures. Members of TIFFE can also be brokers. Therefore there may be non-broker CMs, broker CMs, non-broker CMs, broker CMs, non-member brokers. However, the vast majority of CMs and CMs are also brokers.

Customers cannot operate directly with TIFFE, but only through a broker. Customers carry the risk of the insolvency of the brokers. In other words, if a broker goes bankrupt and owes an amount (either as settlement of a financial futures contract or as margin deposit to be repaid) to a customer, the latter will suffer a loss equal to the difference between the amount due to the defaulted broker under the futures contract and the amount paid pro rata by the liquidator to all *pari passu* creditors of the broker.

Each member has to establish a Member Guarantee Fund (MGF)¹³ for an amount of Yen3 million. If a member is also a broker, such member has to deposit an additional Yen7 million.¹⁴ If a financial futures contract has been concluded with a member (either broker CM or broker CM), the customer shall have a lien on the MGF of such member to secure the performance by such member of its obligations arising from a financial futures contract in preference to any and all other creditors of such member.¹⁵ Such privilege shall be pro rata in favour of all creditors for financial futures contracts.

Apart from the above, the brokers themselves have to maintain a Financial Futures Transaction Liabilities Reserve (FFTLR) and must set aside such amount as may be determined pursuant to the Minister of Finance ordinance. Such reserve which amount cannot exceed Yen10 million may only be utilised as compensating for any losses a customer may incur as a result of a broker defaulting on its obligations.¹⁶

A CM shall, on making a financial futures contract, deposit with TIFFE the margin in an amount calculated in accordance with Article 32 of the Trading and Clearing Regulations of TIFFE. A GM shall, on making a financial futures contract, deposit with its CM the margin in an amount calculated in accordance with Article 33 of the Regulations.

Customers shall, on making a financial futures contract, deposit the margin with the broker in an

amount calculated in accordance with Articles 6 to 11 Futures Contract Terms of TIFFE.¹⁷ Brokers shall take a charge on the margin¹⁸ to protect themselves from the insolvency of their customers. In case of customers' insolvency, the liquidator can claim repayment of the margin only after the broker has satisfied its credit rights.

Conclusion

If the broker is a CM, customers carry the insolvency risk of the CM broker itself (which in turn carries the insolvency risk of the other CMs under the terms of the unlimited pro rata obligation).

Guarantees:

MGF pro rata with all *pari passu* creditors for financial futures transactions

{FFTLR pro rata with all *pari passu* creditors for financial futures transactions}¹⁹

If the broker is a GM or is not a member, customers carry the insolvency risk of the broker itself (GM or non-member) (which in turn carries the insolvency risk of the CM with whom the broker has concluded the contract. In turn the CM carries the insolvency risk of other CMs under the terms of the unlimited pro rata obligation).

Guarantees:

As above (except that MGF cover would not be available if the broker is not a member).

The Legal Framework of Financial Futures Dealings on TSE

Roughly speaking, TSE adopts a framework similar to that of TIFFE. However, the major difference between TIFFE and TSE is that members dealing on TSE do not have the Exchange as legal counterparty (as in TIFFE), but instead have the other member.

The first consequence of this is the reduced possibility of netting (thus increased risk). In other words, if member A buys a specific future from member B and sells the same to member C, there is no offsetting between the two transactions. However, the risk that members carry on other members is reduced by the TSE guarantee of the performance of the members.²⁰ Of course, this undertaking of TSE is subordinated to the utilisation (*beneficium excussionis*) of the Membership Guarantee Deposit (MGD).²¹

11. The LCD is a deposit made by each member for the sole purpose of protecting TIFFE from losses arising from its assumption of payment obligations of financial futures contracts made by members; the LCD amount shall be calculated in accordance with Articles 111 to 110 AA. The maximum amount of the LCD for each member has been set by TIFFE at Yen150 million.

12. Article 56 Law.

13. A deposit made by each member for the sole purpose of protecting its customers and TIFFE as far as CMs' insolvency is concerned from the insolvency of the member itself.

14. Article 18 AA.

15. Article 12, IV, Law; Articles 22 and 41 Law.

16. Article 92 Law.

17. The mechanics of the margin requirement are fairly complex. However, for a three-month Euroyen future, the margin is Yen60,000 of which Yen30,000 is cash and the remaining can be represented by securities.

18. Article 81 Law.

19. Strictly speaking, the counterparty does not have any guarantee (pledge, charge, lien, and so on) on the FFTLR; the reserve is available to cover losses suffered by the customer but no formal preferential right is created.

In addition any claim on the FFTLR is subject to a *beneficium excussionis* on the MGF.

20. Article 96-2-1 of the Constitution.

21. Article 16 Constitution; Articles 12-1-2, 97-4 Securities Exchange Law.

It has to be noted, however, that while TIFFE (being the legal counterparty of each member for all transactions) is unlimitedly responsible towards each member, the TSE guarantee is limited. The TSE guarantee, in fact, is limited to the existing amount of the Default Compensation Reserve for Futures Trading (DCRFT).²² The amount of the DCRFT is variable and there is a relatively complicated way of calculating it. However, the maximum ceiling fixed by the Board of TSE is Yen23,970,000.

This explains why there is no specific provision in the relevant TSE laws/regulations with which is established an unlimited pro rata obligation of the members to reimburse the Exchange in case it suffers losses (such provision is in TIFFE's regulations).

In other words, *members dealing on TSE assume a much bigger risk than their counterparts on TIFFE.*

Inquiries were made in TSE in order to obtain clarification on the above point. TSE officers replied that the Board always has the option to increase the DCRFT. In other words, if a member suffers a loss of Yen100 million and the 'existing amount'²³ is Yen23 million, TSE will pay only Yen23 million, but the day after can increase the DCRFT up to - say - 100 million and use this to pay to the Member the remaining loss of Yen77 million. For the purpose of this analysis, this procedure is called 'replenishment'.

The doubt remains: can TSE apply the new DCRFT to a loss that occurred before? And what happens if the Board does not reach the required majority (two-thirds) to increase the DCRFT? Why is the replenishment procedure not regulated anywhere?

With no clear answer to these questions the following conclusion can be reached: As in TIFFE, customers carry the risk of the member (with which they are dealing) and they are not beneficiaries of the Exchange guarantee (which covers only the members). The reply to the question 'is the TSE guarantee limited or is it - thanks to the replenishment - *de facto* unlimited?' would be interesting because the *de facto* unlimited guarantee would substantially reduce the risk of chain transmission of the insolvency of one member to other members (on the contrary, if the TSE guarantee were limited, members of TSE would carry such risk, while members of TIFFE do not carry the insolvency risk of other members - except pro-rata as TIFFE guarantors). Ultimately, dealing on TSE would be riskier than on TIFFE if the TSE guarantee is limited.

Conclusions

In the discussion above, the TIFFE and TSE structures and regulations relating to the insolvency risk have been described at length. The picture that emerges is the following:

Any entity trading on TIFFE has - as legal counterparty - TIFFE itself, that is to say one of the parties of any financial futures contract is always TIFFE. In this way the systemic risk, that is the risk that the insolvency of one party causes the

insolvency of other parties - the so-called chain transmission of the insolvency - is restrained. If one party defaults, then TIFFE will suffer the loss in case the various margins and deposits are not sufficient to cover such loss.

But the system would not work if TIFFE could become insolvent due to the insolvency of its counterparties. In other words the systemic risk would not be fully eliminated. That is why, in order to eliminate such remote risk, all members undertake to share pro rata such losses, thus becoming guarantors of TIFFE in the interest of the other members. In other words, the members issue a guarantee for an unlimited amount in favour of TIFFE in the interest of *incertae personae* (that is any member, present or future). The insolvency risk of the member is carried ultimately by the other members. Therefore it is basically impossible for TIFFE to become insolvent.

As far as the parties dealing with a member are concerned, the only thing to be mentioned in this conclusion is that their counterparties are the members and they do not benefit from any guarantee or collateral in case of insolvency of the members. Indeed if the member is declared bankrupt, they will rank as unsecured creditor for the repayment of any margin deposits they initially placed with it and for any other claim.

The legal framework on TSE differs from TIFFE in two major aspects. The first is the fact that parties of the financial futures transaction are the members and TSE acts only as guarantor. In other words, party A and party B conclude a transaction and TSE guarantees (1) party A against the insolvency of party B and (2) party B against the insolvency of party A. This solution implies a limited possibility to set off transactions among players. From the insolvency risk point of view the result could be similar to that of TIFFE if the amount of TSE guarantee were unlimited and members were unlimited pro rata counterguarantors of TSE.

However - and this is the second and most important difference from TIFFE - the TSE guarantee is for a limited amount equal to the DCRFT (see above) and, consequently, TSE does not need to benefit from any counterguarantee from its members.

Therefore, if the various margins, deposits and TSE guarantee are not sufficient to cover the losses suffered as a consequence of the insolvency of any member, then the performing member dealing with the insolvent one will be exposed to the losses (while on TIFFE such losses would be shared among members).

These losses could affect the financial strength of the performing member and trigger its insolvency. In other words, the systemic risk would not have been eliminated.

As far as the customers of the members are concerned their position does not differ from their position on TIFFE. In fact their legal counterparties are the members and they do not benefit from any guarantee or collateral in case of insolvency of the members.

However, because TSE members are exposed to the systemic risk, while TIFFE members share pro

22. Article 96-2-1 of the Constitution.

23. *Ibid.*

rate any loss not covered by the margins and deposits, TSB members are in theory riskier counterparties than TIFFE members.

Finally, it seems that TIFFE adopts the clearest, simplest and most straightforward system directed to avoid the chain transmission of the insolvency risk. TSB could have reached the same result if the members had been counterguarantors of TSE. However, the lack of such counterguarantee and of a clear replenishment system leaves some doubts as to the effectiveness of the solution adopted by TSB. A clarification would be more than welcome, especially taking into account the inadequacy of the amount of the DCRPT.

Are Swaps Gambling Contracts?

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The London borough council of Islington failed in its attempts before Hobhouse J in the Commercial Court in April to defeat a claim by Welwyn Hatfield District Council for restitution of amounts paid under an interest rate swap. Islington based its claim on the grounds first that the contract was a gaming or wagering contract which was unenforceable by virtue of the Gaming Acts 1848 and 1892 and, second, that even if the contract was a gaming or wagering contract, it was not exempted from the provisions of the Gaming Acts by virtue of section 63 of the Financial Services Act 1986.

There has always been a residual doubt as to whether a contract for differences, such as an interest rate or currency swap, if entered into by parties other than banks or institutions which are authorised under the Financial Services Act 1986 for the purpose of carrying on investment business, could constitute 'gaming or wagering' contracts. If swaps are 'gaming or wagering' contracts, they may be incapable of enforcement through the English courts by virtue of the Gaming Acts of 1845 and 1892.

The case of *Morgan Grenfell & Co. Ltd v Welwyn Hatfield District Council and Islington London Borough Council* (as a third party) 30 April 1993, in the Commercial Court before Hobhouse J, addresses this question. Hobhouse J handed down his reserved judgment on 30 April 1993. He held that, while swap agreements had potentially speculative characteristics, for a contract to constitute a gaming or wagering contract by virtue of section 18 of the Gaming Act 1845 and section 1 of the Gaming Act 1892, it must have been the intention of both, and not merely one, of the parties at the time of entering into the contract that the purpose of the transaction

was to wager. If the transaction is entered into by parties or institutions involved in the capital market and appears to be a commercial or financial transaction with a potential for wagering, evidence must be adduced to rebut the inference that the transaction is a commercial or financial one to which the law will give full recognition and effect. In such circumstances, the burden of proof is on the party seeking to set the contract aside.

The issue arose, as a preliminary issue, out of an action brought by Morgan Grenfell & Co. Ltd ('Morgan Grenfell') to recover, by way of restitution, amounts paid by it to Welwyn Hatfield District Council ('Welwyn') under a ten-year swap contract between them. It appears that Morgan Grenfell entered into this transaction with Welwyn on the understanding that Welwyn would then enter into a back-to-back agreement on substantially the same terms with Islington. Under this swap, Morgan Grenfell was the fixed-rate payer and Welwyn was the floating-rate payer. The following day, Welwyn, this time as fixed-rate payer, entered into a ten-year swap contract with the London Borough of Islington ('Islington') as floating-rate payer, for the same notional principal amount as under its agreement with Morgan Grenfell. Welwyn took a turn on the transaction with Islington, as it paid Islington a lesser amount by way of up-front payment than it had received from Morgan Grenfell. This amount constituted the profit element to Welwyn of having agreed to intermeddle between Morgan Grenfell and Islington.

Each contract was for a notional principal amount of £25 million and provided that payments, on each side, were to be made semi-annually. By virtue of the netting provisions in each of the agreements, only net amounts owing, after taking into account payments due from each party to the other, were payable on each payment date.

The House of Lords decision in *Hazell v London Borough of Hammersmith & Fulham*¹ resulted in both contracts being void, as they were *ultra vires* the powers of Welwyn and Islington respectively. In Hobhouse J's judgment in the *Westdeutsche Landesbank v Islington*² restitution case in February 1993, he held that amounts which were not recoverable under swap agreements because they were *ultra vires* the powers of the local authorities in question were recoverable from the recipient as money had and received and in equity. Morgan Grenfell and Welwyn agreed, in the present case, to be bound by that decision. However Islington, as a third party to the action, claimed that the supposed contract between Islington and Welwyn was a wagering contract and accordingly provided a defence to Welwyn's claim for restitution.

The question which arose in the *Morgan Grenfell* case was whether Islington had a good defence to Welwyn's claim for restitution on the grounds that:

- (1) the interest rate swap transaction entered into between the parties fell within section 18 of

1. [1991] 2 W.L.R. at 322.

2. *The Times*, 23 February 1993.