Central Counterparties (CCP) and the New Transnational Lex Mercatoria

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November 2010

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Subject: Banking and finance law.

Keywords: CCP systems; the new transnational lex mercatoria; insolvency law; carve-out statutes.

ABSTRACT

This article argues that the new transnational lex mercatoria is the main source of law governing the operations of Central Counterparty (CCP) clearing systems. It demonstrates that the new transnational lex mercatoria has been recognized by the courts in various common law jurisdictions as the appropriate source of law governing the operations various other commercial and financial institutions. It is argued that this new legal regime requires official recognition by the courts in order to protect CCP arrangements from burdensome corporate insolvency laws; especially for the protection of non-financial market CCPs, which are currently not protected by special legislation like their counterparts operating in the financial markets. Therefore, this new legal regime can step in to protect CCP operations where specific legislation has not done so already. Furthermore, it is argued that the new legislative reforms of financial market CCPs in the U.S. and the E.U. will have little impact on the new transnational lex mercatoria as an independent legal regime.

(Word count: 21,975)
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1. INTRODUCTION

This article researches the sources of law governing the operations of Central Counterparty (CCP) systems. The CCP is a *sui generis* financial institution which guarantees and facilitates the settlement of claims between a group of merchants. It will be demonstrated that the new transnational lex mercatoria is the main source of law governing a CCP’s operations. It is submitted that the lex mercatoria should remain the primary source of law governing CCP arrangements because it has worked successfully for decades and there has never been a major CCP failure.1 Although this paper focuses on the law from a common law perspective, the ‘transnational’ aspect of this legal regime means that it applies universally to CCPs operating in most jurisdictions.

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1 CCP failures are rare, but there have been some minor CCP failures in the past in Paris (France) (1973), in Kuala Lumpur (Malaysia) (1983), and in Hong Kong (1987). Raymond Knott & Alastair Mills, A., *Modelling Risk in Central Counterparty Clearing Houses: A Review*, FINANCIAL STABILITY REVIEW, December 2002. Furthermore, there have been a few near failures with the CME (US) (1987), the OCC (US) (1987), and the BM&F (Brazil) (1999). Grant, J., *Push to underpin clearing house foundations*, The Financial Times, June 7 2010. Nevertheless, most major CCPs performed well during the insolvency of Lehman Brothers, and the U.S. Depositary Trust and Clearing Corporation (DTCC) unwound more than $500bn in open trading positions across equities, mortgages and Treasuries between Lehman and a multitude of other banks and investors. It did this without incurring losses for the various counterparties and with no disruption to the financial system. That has provided a certain level of confidence in clearers.
This paper will first give a brief introduction to the operation of CCP systems from a legal perspective. Secondly, it will describe the nature of the new transnational lex mercatoria and argue that it is the desired legal regime for governing CCP operations. Thirdly, it will describe the nature of legislation governing CCP arrangements and the link that it has with the new transnational lex mercatoria. Finally, it will discuss some possible future developments and the impact of the new E.U. and U.S financial reforms on CCP arrangements.

Since the beginning of the 2007-2010 global financial crisis, the U.S. and the E.U. have responded by drafting\(^2\) and enacting\(^3\) sweeping legislative reforms for CCP systems operating in the financial markets. These reforms propose to increase regulatory oversight and reduce the power of CCPs to self-regulate. This will be achieved firstly by proposing an increase in the amount of margin required by a CCP’s clearing members, and secondly, by forcing CCPs to clear ‘standardized’ Over-the-Counter (OTC) financial products that they might not otherwise clear.

The proposed legislative reforms could be a source of legal risk if they are not implemented properly by the relevant regulatory authorities. Imposing a mandatory clearing requirement on certain standardized financial products minimizes certain risks in the markets which those products are traded in. However, regulators should not force CCPs to clear products that they do not wish to assume the risk for. Otherwise, the next financial crisis could arise if a CCP which is considered “too big to fail” becomes insolvent and spreads systemic risk throughout the global financial system.

\(^2\) E.C. Commission Regulation on OTC Derivatives, Central Counterparties, and Trade Repositories, COM (2010) 484/5. (E.U.) [Regulation on CCPs].
\(^3\) Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, H.R. 4173. [Dodd-Frank Act].

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Therefore, the customs and practices of CCP systems should continue to be legally binding on all the members of a CCP. It will be demonstrated that the new transnational lex mercatoria is the legal regime which recognizes the legal validity of these customs and practices.

2. THE LEGAL NATURE OF THE CCP ARRANGEMENT

In the broad sense, a ‘central counterparty’ clearing system is a *sui generis* financial risk management institution that operates by interposing itself between a group of merchants, known as clearing members. The clearing members contractually enter into the CCP arrangement in order to have their transactions centrally cleared on a multilateral basis. The arrangement gives rise to rights and obligations between the clearing members and the CCP.

It is important for the purpose of legal clarity to establish a clear definition of a CCP system. Although a ‘CCP’ is a special type of ‘clearing house’, these two terms are legally distinct, and they should not be used interchangeably, as is often the case in the literature in this area. Whereas a CCP operates as the ‘principal’ to every transaction entered into by the clearing members and clears through a mechanism called ‘multilateral novation netting’, an ordinary clearing house remains an ‘agent’ and does not perform counterparty substitution or assume liability for any of the transactions it clears. It clears through a mechanism known as ‘multilateral position netting’.

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4 ‘Multilateral novation netting’ is often generically referred to as the ‘clearing’ process of a CCP system. It is a process that can be used for (1) substituting counterparties (the counterparty substitution stage) and (2) calculating claims (the multilateral netting stage). Each stage performs a separate novation. The CCP can choose whether to perform the counterparty substitution and the multilateral netting stages together, or whether to bypass the counterparty substitution stage and to perform the netting stage on its own. If the CCP uses this mechanism to perform a counterparty substitution, the concept is referred to as “multilateral netting by novation and substitution”. Alternatively, the CCP can use ‘open offer’ as a mechanism for counterparty substitution.

5 Professor Benjamin Geva has stated that in “position netting, there is no substitution”. See Benjamin Geva, *The Clearing House Arrangement*, 19 CAN. BUS. L.J. 138, 147 (1991).
Initially used in derivatives exchanges, CCPs have increasingly been introduced into securities exchanges, OTC markets, and repurchase agreement markets due to the significant benefits they confer. A CCP arrangement may be entered into by merchants operating in any commercial sector, and CCP systems are not confined to operating in the financial markets. A CCP’s main operations involve risk management, clearing and settlement, and collateral arrangements.

Through either open offer or multilateral netting by novation and substitution, the CCP assumes the contractual rights and obligations of the clearing members as the principal in order to guarantee the performance of each and every clearing member, thereby eliminating counterparty risk. This is known as the counterparty substitution process, which involves the CCP becoming “the buyer to every seller and the seller to every buyer”.

In the context of the financial markets, the CCP interposes itself between a group of institutional market participants that have entered into market transfer orders for financial contracts traded in one or more markets. The CCP, in effect, guarantees the termination of any

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6 For example, the Australian case of International Air Transportation Association (IATA) v. Ansett, [2008] H.C.A. 3 (Austl.) [Ansett], and the United Kingdom case of British Eagle International Airlines Ltd v. Compagnie Nationale Air France, [1975] 1 W.L.R. 758 (H.L.) [British Eagle], dealt with a non-financial market CCP system for the aviation industry – the International Air Transportation Association clearing system.

7 Open offer is a unilateral contract in the form of an ‘offer’ to enter into a contractual relation which is ‘open’ to the clearing members of the CCP to accept by conduct. In the context of CCP arrangements, the CCP, as promisor, undertakes to assume the rights and obligations of a clearing member (the promisee) as central counterparty if the clearing member accepts the CCP’s offer by entering into a transaction of the kind stipulated in the clearing arrangement.

8 See supra note 6.

9 ‘Counterparty credit risk’ is the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter. Counterparty risk includes ‘pre-settlement/replacement cost risk’, which is the risk that a counterparty to a transaction for completion at a future date will default before final settlement, with the resulting exposure being the cost of having to replace the original transaction at current market prices. It also includes principal risk, which is the risk that the seller of an asset delivers it but does not receive payment, or that the buyer of an asset makes payment but does not receive delivery. See generally infra note 10.

10 The Committee of Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) Recommendations for Central Counterparties, CPSS Publications No. 64 November 2004, Annex 3; Glossary, at 64. [RCCP]. These were composed under the auspices of the Bank for International Settlements (BIS).
position in fungible executory contracts\textsuperscript{11} with standardized terms that any of the clearing members may desire. The clearing stage involves the CCP performing multilateral novation netting to reduce the amounts outstanding between each clearing member and the CCP to net amounts. Furthermore, the CCP can perform multilateral close-out netting upon the insolvency of a clearing member. This guarantees that the clearing members settle their claims before the ordinary creditors of the insolvent clearing member.

In the non-financial markets context, a CCP guarantees the performance of obligations, generally consisting of debts,\textsuperscript{12} upon the insolvency of a clearing member. The clearing stage involves multilateral set-off, and the CCP can perform multilateral insolvency set-off\textsuperscript{13} upon the insolvency of a clearing member.

The legal and economic benefits have proven to decrease certain risks\textsuperscript{14} inherent in clearing systems and have provided efficiency gains by lowering costs. CCPs are relatively new and increasingly important financial institutions which are not yet fully understood and consequently require legal analysis and clarification to ensure their proper functioning. A crucial requirement for their operations is “a well founded, transparent and enforceable legal framework

\textsuperscript{11} ‘Netting’ and ‘set-off’ serve the same function. They both discharge gross claims to a single net amount. E.g. if X owes 10 widgets to Y, and Y owes 5 widgets to X, then after netting or set-off, X will pay 5 widgets to Y. The key difference between set-off and netting is that ‘set-off’ deals with debts, whereas ‘netting’ deals equivalent fungible claims under executory contracts. See PHILIP R. WOOD, SET-OFF AND NETTING, DERIVATIVES, CLEARING SYSTEMS (2d ed., Sweet & Maxwell, 2007), at paras. 1-006, 1-022.

\textsuperscript{12} See id.

\textsuperscript{13} Insolvency set-off is a type of set-off arising where one of the debtor-creditors is insolvent. Since insolvency set-off is mandatory and automatic for corporate insolvencies in many common law jurisdictions, the risk arises that if all the requirements for set-off are not satisfied before insolvency, the use of the set-off facility will not be permitted in CCP systems. See generally, WOOD, supra note 11.

\textsuperscript{14} These risks are counterparty credit risk, systemic risk, settlement bank risk, custody risk, liquidity risk, investment risk, legal risk, and operational risk. See generally RCCP, supra note 10.
for each aspect of its activities in all relevant jurisdictions”,15 thereby providing legal certainty to the system operators and participants.

The legal literature on ‘clearing and settlement’ is complex and confusing as it fails to take a uniform approach in terminology usage, thereby overcomplicating theoretical concepts and processes. A further source of legal uncertainty may be the legal complexities that can arise when dealing with cross-border CCPs operating in multiple jurisdictions.

(a) The Importance of Avoiding Legal Risk

Legal risk is the most important risk for lawyers to manage. It is the risk that a party will suffer a loss because laws or regulations do not support the rules and contracts of the CCP or the property rights and other interests held through the CCP. Legal risk has the potential to decrease confidence in the CCP system and to substantially increase the losses associated with a default for the CCP, its participants, and even the wider financial community where there may be systemic risk involved. Legal risk may arise if the application of laws and regulations is unclear, and it may increase for CCPs operating in a cross-border context.

This requires that the laws and regulations governing a CCP should be clearly stated with respect to its rules, procedures, contractual arrangements, and the time of counterparty substitution. Further, the laws must be internally coherent and readily accessible to the participants and the public. In the case of British Eagle International Airlines Ltd v. Compagnie

15 Recommendation 1, RCCP, at 4, ‘Legal Risk’. Emphasis added. This recommendation originates from the BIS, Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Lamfalussy Report), CPSS Publications, November 1990, which outlines the six minimum standards for netting schemes. The first requirement is for netting arrangements to have a well-founded legal basis under all relevant jurisdictions.
Nationale Air France it was demonstrated that if the legal framework is underdeveloped, opaque and inconsistent, the resulting risk will undermine a CCP’s ability to operate effectively.

Some jurisdictions have drafted specific legislation to avoid legal risk and to protect their financial markets. These statutes, known as “carve-outs”, protect certain financial market operations from the burdensome effects of domestic corporate insolvency laws. However, the majority of these statutes were not specifically drafted for the exclusive protection of CCP systems, and tend to apply to a wider spectrum of financial institutions.

For instance, Recommendation 4 of the CPSS-IOSCO Recommendations for Central Counterparties 2004 requires the legal system governing a particular CCP arrangement to support “novation” and “open offer” as mechanisms for counterparty substitution. Yet the majority of carve-out statutes do not expressly recognize “open offer”. Moreover, the recent legislative reforms passed in the U.S. and E.U. for financial market CCPs make no mention of these counterparty substitution methods.

Since the carve-out statutes only protect financial market CCPs, non-financial market CCPs have attempted to achieve a similar level of protection by drafting their clearing rules in a manner which satisfies their business needs. It is submitted that non-financial market CCP arrangements are protected by a legal order known as the new transnational lex mercatoria, which recognizes and gives legal force to their customs and practices. This legal order protects their arrangements where other laws might not. It suggests, as a matter of commercial policy,

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16 Supra note 6.
17 Dodd-Frank Act, supra note 3.
18 E.C. Regulation on CCPs, supra note 2.
that CCP arrangements are exempted from corporate insolvency laws that may hinder their operations.

3. THE NEW TRANSNATIONAL LEX MERCATORIA

In *Goodwin v. Robarts* (1875),\(^{20}\) Cockburn C.J. stated that the “law merchant” forms a part of the general body of the lex mercatoria. It was described as:

> “the usages of merchants and traders in the different departments of trade, ratified by the decisions of Courts of law, which, upon such usages being proved before them, have adopted them as settled law with a view to the interests of trade and public convenience. [The Courts of law], in giving effect to the contract and dealings of the parties, will assume that the latter have dealt with one another on the footing of any custom or usage prevailing generally in the particular department. By this process, what before was usage only, unsanctioned by legal decision, has become engrafted upon, or incorporated into, the common law, and may thus be said to form part of it”.\(^{21}\)

In support of this description of the lex mercatoria, Lord Chorley has stated that Cockburn C.J.’s dictum on the judicial recognition of mercantile usage “should be inscribed in letters of gold in every Court handling commercial litigation”.\(^{22}\)

Consequently, the usages, practices, and customs of merchants adopted by the courts can form the new transnational lex mercatoria. This understanding of the lex mercatoria supports Professor Jan Dalhuisen’s new legal framework,\(^{23}\) who posits that there is a newly developing custom in the globalised commercial and financial legal order which is leading to the creation of the modern transnational lex mercatoria in the professional sphere.\(^{24}\) He has laid the groundwork for a ‘new transnational lex mercatoria’, which he claims has been an evolutionary process that has been long underway. This legal order will manifest itself ever more prominently in the years

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\(^{20}\) L.R. 10 Exch. 337.

\(^{21}\) At 346. Emphasis added.


\(^{23}\) See Dalhuisen, *Lex Mercatoria, supra* note 19.

\(^{24}\) “The modern key issue is whether there now exists a sufficiently independent international commercial and financial legal order in the professional sphere in which legal relationships between parties operating in that order are or can be detached from a domestic environment and be subject to the legal principles and rule obtaining in that order”. Dalhuisen, *Lex Mercatoria, supra* note 19, at 146.
to come.\textsuperscript{25} In support of this view, this article will demonstrate that its manifestation is already evident in the context of CCP systems.

Professor Dalhuisen’s framework for a new transnational lex mercatoria provides for the acceptance of multiple sources of law operating through a \textit{hierarchy of norms}.\textsuperscript{26} It operates as an independent transnational legal order in which international commercial and financial transactions are governed by a regime that is detached from domestic legal orders.

The modern lex mercatoria is based on the natural law school of jurisprudential thought and it implies a reversal of codification by using notions of fairness or natural justice in deciding modern international commercial needs. This reversal of codification and legislation has been evident over the past three decades in the jurisdictions of the major financial markets,\textsuperscript{27} which have seen a period of financial deregulation.

The financial market carve-out statutes,\textsuperscript{28} which protect certain arrangements of the financial markets from domestic corporate insolvency laws,\textsuperscript{29} have been introduced to reify the customs and practices of CCPs. In order to provide legal certainty, CCPs require an exemption from certain provisions of corporate insolvency laws to protect their operations. Consequently,

\begin{itemize}
  \item \textsuperscript{25} See Dalhuisen, \textit{Lex Mercatoria}, supra note 19, at 191.
  \item \textsuperscript{26} This is subject only to justified domestic public policy corrections.
  \item \textsuperscript{27} Viz. the U.K., E.U. and U.S.
  \item \textsuperscript{29} The carve-out statutes were passed to protect the operations of CCPs from the following domestic corporate insolvency statutes: \textbf{England}: The Insolvency Rules, rule 4.90, 1986; \textbf{United States}: The Bankruptcy Code 1978, s. 553; \textbf{Canada}: The Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3- 2009, s. 66 (1), s. 97 (3), and the Companies’ Creditors Arrangement Act (CCAA), s. 21. \textbf{Australia}: The Corporations Act 2001.
\end{itemize}
domestic corporate insolvency statutes are being suppressed by the carve-out statutes in the context of financial market CCP systems. They are also being suppressed by the common law courts in the context of non-financial CCPs, as the recent case of *International Air Transportation Association (IATA) v. Ansett* suggests.\(^{30}\)

However, it will be discussed below that the trend of reversing codification and minimizing financial regulation appears to be coming to an end in the U.S. and E.U. These jurisdictions have introduced new legislation that will govern CCP operations commencing in 2010.

(a) **Transnationalization of the Law**

The transnationalization of this law aims towards the development of substantive transnational standards that are result-oriented. This requires an eventual fusion of the different perspectives of civil and common law to achieve a neutral and unitary legal approach for modern trade and finance. It is ultimately concerned with the proper operation of parallel legal orders that possess disparate competencies in governing relationships or transactions within their reach.\(^{32}\)

A formal recognition of the new transnational lex mercatoria should not be problematic in most common law jurisdictions. For instance, Canadian courts have for a long time recognized the “transnational” aspect of the law merchant. In *Union Investment Co. v. Wells* (1908), Duff J. stated that “the broad features” of the law merchant were similar in all countries. Therefore, it is not only acceptable, but desirable, “when the point for decision is a question arising upon the law

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\(^{30}\) *Supra* note 6.

\(^{31}\) The *Ansett* decision suggests that the rules of a CCP system may be able to override conflicting corporate insolvency laws in the context of non-financial market CCPs such as the International Airline Transportation Association (IATA) clearing system.

\(^{32}\) See Dalhuisen, *Lex Mercatoria, supra* note 19, at 188.
merchant and is also one upon which English authority is wanting, to have recourse to the law of other commercial countries”. 33

(b) The Hierarchy of Norms

Professor Dalhuisen has posited that the transnational new lex mercatoria is:

“built on fundamental and general principles, on custom and perhaps in some areas even on uniform treaty laws, but may residually still use private international law rules pointing to a domestic legal system as well. The key then is the hierarchy between these various sources of law... to know what law prevails in that order and how it can be found”. 34

The hierarchy of norms in the new lex mercatoria should be strictly applied in the following order: 35

(1) the fundamental legal principles (ius cogens), which are based on the laws of contract, agency, property, tort and restitution, form the basis of modern legal orders;

(2) mandatory customs or practices;

(3) mandatory uniform treaty law;

(4) the contract;

(5) directory customs or practices.

34 See Dalhuisen, Lex Mercatoria, supra note 19, at 157.
36 This includes the principle of the pacta sunt servanda, establishing the binding force of promises.
37 This includes fiduciary duties.
38 This includes the principle of ownership, encompassing protection, exclusivity, and transferability of proprietary rights.
39 This includes negligence liability and detrimental reliance.
40 This includes unjust enrichment.
41 “Fundamental principles must be supported and further directed by established practices or custom, which in their supporting role could then also become mandatory”. Dalhuisen, Lex Mercatoria, supra note 19, at 182-183.
42 For example, this may derive from standards set by the E.U., BIS, the World Trade Organization, UNCITRAL, or UNIDROIT.
43 This includes the notions of pacta sunt servanda and party autonomy used in drafting the contractual terms, and the incorporation of standard terms.
(6) directory uniform treaty rules;\textsuperscript{45}

(7) general legal principles;\textsuperscript{46}

(8) domestic laws found through conflict of laws rules.\textsuperscript{47}

Professor Dalhuisen justifies the inclusion of this last source of law by arguing that:

“the introduction of domestic law as the residual rule makes the lex mercatoria a system of law that is at least as complete as any other and overcomes any argument ... that [this system] ... cannot operate because it is not a fully operative system. That is a misconception. The key is that only domestic law so applied will increasingly be preceded by industry practices, customs and general principles and that such domestic law then figures as part of the transnational law and is fitted in accordingly”.\textsuperscript{48} “The result is ... a layering of norms and their hierarchy, which ... is the essence of the modern lex mercatoria”.\textsuperscript{49}

\textbf{(c) The Binding Force of Customs and Practices in the OTC Markets}

The informal and unregulated OTC markets have successfully developed their own market practices for derivatives transactions with the International Swaps and Derivatives Association (ISDA) and Repo Master Agreements, which have become legally binding under New York law and English law. These customs and practices have arguably become transnational law.\textsuperscript{50} In support of this view, Professor Dalhuisen argues that:

“the ISDA Swap Master Agreements may well have acquired their own transnational status superseding in reality the domestic law declared applicable by the parties ... or any domestic mandatory law resulting under conflict of laws rules ... Even the applicable domestic bankruptcy laws may increasingly have to accept the ISDA netting agreements as an expression of the international market practice or custom in the context of the hierarchy of norms of the modern lex

\textsuperscript{44} This may include the rules or recommendations of International Capital Markets Association, the Uniform Customs and Practices for Documentary Credits (UCP), or BIS.

\textsuperscript{45} The binding force of these rules may be limited to transactions between ratifying states, e.g. the Vienna Sales of Goods Convention.

\textsuperscript{46} These are legal principles which should be distinguished from the fundamental legal principles, and are derived from comparative law, uniform treaty law, International Chamber of Commerce rules, and Master Agreements.

\textsuperscript{47} However, domestic laws play a residual role, and should only be applied when there is still no solution in the upper hierarchy.

\textsuperscript{48} See DALHUISEN, supra note 35, at 160. Emphasis added.

\textsuperscript{49} Dalhuisen, Lex Mercatoria, supra note 19, at 185. Emphasis added.

\textsuperscript{50} See DALHUISEN, supra note 35, at 494-495. For example, OTC market participants have developed the concepts of ‘flawed asset’ and ‘conditionality’ as alternatives to set-off.
mercatoria. They could then amount to mandatory practice or customary law binding also on bankruptcy courts”. 51

This suggests that OTC market practices are part of the new transnational lex mercatoria. This can be applied by analogy to CCP systems operating on regulated stock and derivatives exchanges, since the OTC markets and the regulated exchange markets are two halves of the same coin. Therefore, CCPs operating on exchanges have emulated a similar strategy by adapting their customs and practices to suit their business needs.

Consequently, it is arguable that the customs and practices of CCPs operating on exchanges have also acquired a transnational legal status. These have their own legal binding force and are reflected in the CCP clearing rules.

Due to the specialist and sophisticated nature of the activities carried out by participants in both the unregulated OTC and the regulated exchange markets, it is necessary as a matter of public policy to give CCP systems contractual freedom. This allows them to by-pass redundant and burdensome legal rules so that they can carry out their business in a manner that is more efficient, wealth maximizing for society in general, and which also attains the ultimate goal of risk management.

(d) Justification for a New Transnational Lex Mercatoria

The problem with domestic laws is that they may not have been developed to be applied to sophisticated legal transactions. For example, domestic corporate insolvency laws have proven burdensome to CCP systems in the past, as the English House of Lords 52 decision in *British Eagle* and the Australian High Court decision in *Ansett* demonstrate. Domestic laws dealing with international finance and commerce are static and present a fractured system of law, which

51 *Id.* at 523. Emphasis added.
52 The House of Lords was renamed the Supreme Court of the U.K. in October 2009.
creates legal uncertainty, inefficiency and inequality. Therefore, the rules and principles derived from the customs and practices of sophisticated market institutions such as CCPs supersede the application of domestic rules in international commerce cases. As a result, domestic law is the residual rule and is incorporated into the lex mercatoria by operating only in that context.

The new transnational lex mercatoria is a response to the increased international flow of goods, payments, services, and capital. It has been compared to a “new transnational law of equity”. It is dynamic and can deal with efficiency considerations and values as a matter of ‘conscience’, and it recognizes the objective needs of the participants in the international business community. In support of a transnational legal system modeled on the law of equity, Professor Joanna Benjamin has argued that:

“the dominance of common law (as opposed to civil law) in international finance is... largely due to the creative development of property rights in equity... The fundamental achievement of equity is to permit property rights to extend to the intangible and unallocated assets on which the international financial markets are based... This is an important respect in which English law can contribute to the development of commercial law in Europe”.

The new transnational lex mercatoria should be as flexible and as dynamic in meeting and adapting to the needs of the international financial community as the law of equity is in common law jurisdictions.

The benefit of using custom as a source of law at top of the hierarchy is that it can suddenly change in a short period of time if business requires it. Professor Dalhuisen has called this “the epitome of legal dynamism, which is... at the heart of the international commercial and financial legal order”. CCPs, as self-regulatory organizations (SRO), are in the best position to

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53 This refers to equity in the common law sense.
54 This term refers to ‘conscience’ in the law of equity sense of the word.
55 See Dalhuisen, Lex Mercatoria, supra note 19, at 190.
57 See Dalhuisen, Lex Mercatoria, supra note 19, at 168.
draft their own system rules, since they understand the nature of their own business. Recent examples suggest that politicians, legislatures, regulators and judges\textsuperscript{58} are not the best suited parties to determine the operations and rules governing CCP systems, due to the esoteric and complex nature of their operations. Therefore, the customs and practices of CCPs should be adhered to in order to provide CCPs with legal certainty.

This new transnational legal order would apply only to professional or sophisticated market participants, whereas the domestic legal order would continue to apply to consumers, which require special protection. The business community, and more specifically CCP systems, should have their customs and practices enforced in the form of the new lex mercatoria in order to ensure efficiency, rationality, consistency, and predictability for themselves and their participants.

Professor Dalhuisen suggests that:

“the need to decrease transaction costs and facilitate exchange are themselves important motivators of the new transnational law and would stop the earlier situation in which the costs of a fractured legal system were shifted to weaker and less informed parties” \textsuperscript{59}

For example, the losses associated with the insolvency of a clearing member in a CCP would be passed on to the consumers of the solvent clearing members if multilateral netting were prohibited.\textsuperscript{60} Furthermore, the losses associated with systemic risk would ultimately be borne by taxpayers.

\textsuperscript{58} As the \textit{British Eagle} and \textit{Ansett} decisions suggest.

\textsuperscript{59} See Dalhuisen, \textit{Lex Mercatoria}, supra note 19, at 165.

\textsuperscript{60} The IATA clearing system could not perform multilateral netting after the insolvency of a clearing member in \textit{British Eagle}, which cost the solvent clearing members time and money.
The Importance of the New Transnational Lex Mercatoria

The new transnational lex mercatoria is the legal regime governing the operation of both financial market and non-financial market CCP systems. However, in the context of financial market CCPs, most jurisdictions have introduced special financial market-carve-out statutes to protect these systems from the burdensome effects of domestic corporate insolvency laws. These special statutes have codified the customs and practices of CCPs. Therefore, where a carve-out statute is silent on a particular issue, the courts should look at the lex mercatoria to answer a particular legal question.

Since non-financial market CCPs do not receive the same statutory protections from corporate insolvency laws as financial market CCPs, the new transnational lex mercatoria provides them with analogous protection. The carve-out statutes and the new transnational lex mercatoria recognize the customs and practices of CCP systems and protect them from corporate insolvency laws.

The new transnational lex mercatoria should protect CCP arrangements and allow CCPs to achieve bankruptcy resistance\(^{61}\) for the operations they typically perform. In other words, domestic corporate insolvency laws should not interfere with and hinder crucial risk management operations of CCP systems, such as multilateral netting and close-out netting upon the insolvency of a clearing member or the CCP. This would defeat the purpose of having a CCP system in the first place. CCPs operating in common law jurisdictions have already achieved bankruptcy resistance through the development of contractual netting, which allows CCPs to satisfy the ‘mutuality’\(^{62}\) requirement for achieving insolvency set-off.

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\(^{61}\) Professor Dalhuisen argues that transnationalization of the law appears to be the only solution for financial products to achieve bankruptcy resistance. See Dalhuisen, Lex Mercatoria, supra note 19.

\(^{62}\) The creation of mutuality is important because it represents the point in time in which counterparty substitution takes place between the clearing members and the CCP. The clearing members require counterparty substitution in
(f) **Enforcement of the New Transnational Lex Mercatoria**

In order to be effective, the new lex mercatoria requires recognition and enforcement by international arbitrators, financial regulators and state courts. It is possible that the application of the new lex mercatoria by national courts would be analogous to how E.U. Member State courts apply European law by acting as European courts when deciding E.U. issues. It will be demonstrated that this has already occurred for clearing houses and CCP systems, which is evident from the importance that the common law courts have given customs and practices of clearing and settlement systems. However, since CCPs have proven an ability to enforce their own rules successfully, the intervention of the courts has rarely been necessary for resolving disputes.

4. **CUSTOMS, PRACTICES AND USAGES**

The courts of various common law jurisdictions have recognized in several decisions the customs, practices and usages of merchants as the main source of the lex mercatoria. These are often reflected expressly in the clearing rules.

A ‘custom’ operates either (i) as a separate source of law, (ii) through statute or (iii) through implied contractual terms. More specifically, a custom has been described as a rule which has obtained the force of law in a particular locality. A ‘usage’ is the settled ‘practice’ of a

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order for the CCP to become the principal and assume liability for all the transactions entered into by the clearing members. Professor P.R. Wood has written that the doctrine of mutuality requires that (1) there must only be two counterparty claimants in the capacity of debtor-creditor prior to an insolvency, (2) that each claimant is both the beneficial/economic owner (not the legal owner) of the claim owed to it or a clear partitioned share of it and, (3) each claimant is personally liable on the claim owed by it, and is not liable in some representative capacity such as trustee or agent. The reciprocal claims do not have to arise under the same transaction, connected transactions, or transactions of the same type. A debt that arises after bankruptcy may be considered non-mutual and could therefore not be set-off against a debt that arises before the bankruptcy. *See* WOOD, *supra* note 11, at paras. 2-006 and 4-001.

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63 Since the courts use the terms customs, practices and usages interchangeably, this article does as well.
64 *See* DALHUISEN, *supra* note 35, at 149.
particular trade or profession. A custom that becomes legally enforceable, such as a trade or industry practice, is known as a ‘custom proper’.

It is well established that the common law jurisdictions, unlike civil jurisdictions, develop customary law through the common law and equity law. They allow a flexible development of the law by going beyond statutory law and by adhering to the customs and practices of sophisticated institutions through the use of implied terms. This is done in order to achieve the desired economic interests of the contracting parties.

Customs, practices or usages may be used to interpret a contractual agreement, but they may not vary or contradict the express terms of the contract. This is consistent with the contract law principle that express terms cannot be overridden by conflicting implied terms. Therefore, customs and practices in the form of implied terms are used to fill in the gaps and give interpretation to clearing arrangements.

(a) Recognizing New Customs, Practices and Usages

Professor Chorley stated that the “changed conditions of business give rise to new usages among those engaged in it... A sympathetic yet critical reception of new customs seems to me to afford the very means of keeping the law merchant abreast with the requirements of modern

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65 “In the field of commercial law ... the custom of merchants has always been a fruitful source of law”; Kleinwort Benson Ltd. v. Lincoln City Council, [1999] 2 A.C. 349 at 394, per Lord Lloyd.
66 Part D.1.3.32.1 of the pre-19th Century ius Commune (Roman law) stated that statutory law (leges) could be superseded by custom (non-usus) as the implied will of the people. Section D.1.3.12/13 permitted the combination of statutory law and local custom as falling under one class. Section D.1.3.34 suggests that case-law is the most certain source of knowledge concerning custom. See DALHUISEN, supra note 35, at 150.
commerce which we are looking for”. Therefore, the courts have to be able to identify new CCP customs and practices in order to provide legal certainty.

Firstly, the recognition of a custom, practice or usage by the court is a question for the law of evidence. In *Cunliffe-Owen v. Teather and Greenwood*, Ungoed-Thomas J. stated that:

“‘usage’ as a practice which the court will recognize is a mixed question of fact and law. For the practice to amount to such a recognized usage, it must be certain, in the sense that the practice is clearly established; it must be notorious, in the sense that it is so well known in the market in which it is alleged to exist, that those who conduct business in that market contract with the usage as an implied term; and it must be reasonable”.

Secondly, a custom must be more than a course of action habitually followed, requiring consistency and regularity, and must be recognized as binding by the parties. Although the English courts have considered the applicability of a custom as a subjective matter in some contexts, which needs to be proven by the party relying on the custom, it appears that in some contexts objective custom has been recognized. Whereas the subjective approach demonstrates

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68 See Chorley, supra note 22, at 51-52.
69 Chorley correctly asserts that “the great difficulty which lawyers feel about these trade customs is their uncertainty. They are apt to come and go, they alter in character, they vary from place to place. If a custom has once been found by the Court and declared to be the law, what is to happen when later the custom is found to have altered?” *Id.* at 59.
71 Emphasis added. The dictum of Farwell L.J. in *Devonald v. Rosser & Sons*, [1906] 2 K.B. 728 (Eng.) at 743, a case which dealt with negotiable instruments, is precedence for this authority. The New Brunswick Court of Appeal in Canada followed the ratio in *Cunliffe* in *MacManus Realty Ltd. v. Bray* (1970), 14 D.L.R. (3d) 564 (N.B.C.A.) (Can.), where Hughes J.A. stated that “a custom to be legal and valid must be reasonable, certain and notorious and consistent with good morals and sound policy ...”. At 568.
73 *Cunliffe-Owen v. Teather & Greenwood*, [1976] 1 WLR 1421 (Eng.); “What is necessary is that for a practice to be a recognized usage it should be established as a practice having binding effect”, at 1438. Followed by Oliver L.J. in *General Reinsurance Corp. and Others v. Forsakringsaktiebolaget Fennia Patria* at 876.
74 Lord Atkinson in *Produce Brokers C., Ltd. Appellants v. Olympia Oil and Cake Company*, [1916] 1 A.C. 314 (H.L.) (U.K.) stated that “the language expressing a trade custom is taken to be imported into the language used by the contracting parties, whether written or verbal, because it is presumed that they had the usage in their minds when they made their contract, made it in reference to that usage, and intended that the usage or custom should form part of it. If they have used language in their contract inconsistent with the custom, that is one of the most effectual ways of negativing this presumption, excluding the custom, and declaring that their contract is unaffected by it”, at 324. Emphasis added.
75 “The burden lies on those alleging “usage” to establish it”; *Cunliffe-Owen, supra* note 73, at 1438.
76 See DALHUISEN, supra note 35, at 152.
that English law gives effect to the parties’ stated intentions, the *objective approach* applies a set of objective customs and practices where the parties’ intentions have not been expressed. The objective approach is preferred, since it better protects CCP arrangements.

Thirdly, the English court in *Edelstein v. Schuler & Co.*\(^77\) discussed the speed at which a custom can be established and recognized by the courts. Bingham J. argued that “in these days *usage* is established much more quickly than it was in days gone by; more *depends on the number of the transactions* which help to create it than on the *time* over which the transactions are spread”.\(^78\) The courts have demonstrated a willingness to recognize customs which are of recent origin,\(^79\) and this supports a policy of promoting the dynamic needs of the financial community by allowing CCP systems to speedily change their customs and practices overnight in order to satisfy their business needs.

**b) Approach for Recognizing a New Custom, Practice or Usage**

In support of the objective approach for recognizing a particular practice, Gatehouse J. in *Harlow and Jones Ltd. v. American Express Bank Ltd. and Creditanstalt-Bankverein*\(^80\) interpreted a contract on an “objective basis” by considering the interpretation that would be placed on the contractual documents by “reasonable bankers in the position of the parties at the time, having regard to the factual background known to both of them, or which must be *taken to have been known to them*”.\(^81\) He considered that these bankers would also be “aware of the

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\(^77\) [1902] 2 K.B. 144 (Eng.) at 154.

\(^78\) Emphasis added.

\(^79\) *Bechuanaland Exploration Co. v. London Trading Bank Ltd.*, [1898] 2 Q.B. 658 (Eng.).

\(^80\) [1990] 2 Lloyd's Rep. 343 (C.C.) (Eng.).

\(^81\) Emphasis added.
common practices” of bankers.\textsuperscript{82} It was found to be clear beyond argument that the parties in this case subscribed to the rules or customs in their operations manual.\textsuperscript{83}

The customs and practices of CCP systems have already become transnationalized, and it is evident that CCP systems that operate across borders are observing and implementing each other’s practices in order to seek conformity with universal industry standards. These transnational guidelines aim to achieve international convergence\textsuperscript{84} on the requirements for CCPs; and they clearly codify their practices.

CCP industry practices can be found in the standard terms\textsuperscript{85} or written guidelines of industry bodies such as the Bank for International Settlements (BIS), International Organization of Securities Commissions (IOSCO) and the International Swaps and Derivatives Association (ISDA). If these bodies are recognized as the official standard setters for the relevant legal order, they can regularly change and update the guiding rules and principles to incorporate new customs and practices without detracting from their enforceable nature.

For example, the new E.U. Commission Regulation on OTC Derivatives, Central Counterparties and Trade Repositories\textsuperscript{86} expressly adheres to the IOSCO-CPSS

\begin{itemize}
\item \textsuperscript{82} At 348. The decision held that the International Chamber of Commerce ‘Uniform Rules for Documentary Credits’ did not need to be expressly incorporated into the relevant contract because “the expert witnesses ... were agreed that all banks operating in England subscribe to the Uniform Rules”, at 349. Emphasis added.
\item \textsuperscript{83} The same approach was taken by the U.S. court in Oriental Pac. (USA) Inc. v. Toronto Dominion Bank, 357 N.Y.S.2d. 957 (N.Y. 1974), which recognized the force of UCP as transnational law.
\item \textsuperscript{84} Preamble, para. 49. “It is important to ensure international convergence of requirements for central counterparties ... This Regulation follows the recommendations developed by CPSS-IOSCO ... and creates a Union framework in which CCPs can operate safely. ESMA [European Securities and Markets Authority] should consider these developments when drawing up the regulatory technical standards as well as the guidelines and recommendations foreseen in this Regulation”.
\item \textsuperscript{85} A bank’s standard terms of trading are incorporated into the banker-customer contract either expressly or by implication; Emerald Meats (London) Ltd. v. AIB Group (UK) plc., [2002] EWCA Civ. 460 (Eng.). By analogy, a CCP’s standard terms may be expressed or implied in the clearing rules. However, it must be noted that there is one important difference between the banker-customer relationship and the CCP-clearing member relationship – the former is an agent-principal relationship (Joachimson v. Swiss Banking Corpn., supra note 125), whereas the latter is a principal-principal relationship.
\item \textsuperscript{86} E.C. Regulation on CCPs, supra note 2.
\end{itemize}
Recommendations for CCPs 2004\textsuperscript{87} and the other recommendations of the CPSS-IOSCO. Furthermore, the Canadian Derivative Clearing Corporation (CDCC) recognizes in its Risk Management policy that “in addition [to following the RCCP], the CDCC studies the practices used at other clearing corporations in order to meet industry standards as well as customer needs, with respect to its own legal environment”.\textsuperscript{88} This voluntary harmonization of industry practices is being done to achieve more consistency in the market practices adopted by CCP systems in order to lower costs, and increase efficiency by adopting the best and most innovative markets practices available.

Therefore, if a court were to apply the objective approach in the Harlow decision to determine which set of rules and laws govern a CCP’s arrangements, it should find that it is governed by the RCCP, which is recognized by the new transnational lex mercatoria. It must be the common intention of all the members when contracting to be part of such a system to adhere to a common set of core principles and rules that govern CCP operations, unless the members have expressed otherwise.

Consequently, the practical need to achieve adequate legal protection for arrangements entered into by merchants across borders means that a new objective legal order is necessary – one which recognizes the binding force of international customs and practices of CCP arrangements notwithstanding any laws to the contrary. The new transnational lex mercatoria is such a legal regime.

\textsuperscript{87} [RCCP].

\textsuperscript{88} Information Statement on Risk Management at CDCC (2007). Emphasis added.
5. SOURCES OF LAW

In order to pinpoint a source of law governing CCP operations, it is important to note that due to the nature of the operations they perform, these systems have their origins in commercial law. This encompasses the law of negotiable instruments and banking law.

In England, commercial law allows businessmen to regulate their own affairs through mercantile usage. Lord Parker stated in *Produce Brokers C., Ltd. Appellants v. Olympia Oil and Cake Company* \(^{89}\) that “mercantile contracts ... fall to be interpreted by the light of any custom prevailing in the trade”. Furthermore, Willes J. stated in *Hare v. Henty* (1861)\(^{90}\) that “a man who employs a banker is bound by the usage of bankers”. This authority is important for the validity of a CCP’s rules because, like banks, these systems incorporate their customs and practices into their arrangements via contract.

(a) Negotiable Instruments Law as a Source of the Lex Mercatoria

Negotiable instruments law is an important source of law which has influenced the development of the lex mercatoria. Professors Sealy & Hooley have stated that “the important reason for examining the law relating to negotiable instruments is because it encapsulates many of the fundamental principles and concepts of commercial law in general ... [including] mercantile custom and usage”.\(^{91}\) Professor J.S. Rogers\(^ {92}\) has also considered the evolution of the lex mercatoria in the context of negotiable instruments law. He cites Cockburn C.J. in *Goodwin*
v. Robarts as an example of the courts willing to adhere to a mercantile practice in which bankers treated government scrip as “negotiable” by delivery.

The statutory recognition of the negotiability of promissory notes with the passing of the Promissory Notes Act 1704 in England is a key example of the legislature codifying previous judicial acceptance of a mercantile usage. Although there has been some academic debate as to whether promissory notes were “negotiable” prior to the legislative enactment, most academics agree that the 1704 Act was declaratory of the case law as it existed prior to the controversial case of Clerke v. Martin (1702).

In Clerke v. Martin, Lord Holt held that a promissory note payable to order was not a bill of exchange, and therefore was not “negotiable”. Professor Holden has argued that the decision in Clerke was correct and that promissory notes had not been recognized as negotiable prior to that decision. However, Professor Holdsworth has argued that the legislature intervened with the 1704 Act to reverse the undesired effects of the Clerke decision as they went against the business practices and needs of the mercantile and banking community at the time. The legislature’s intention was to teach the courts that “they could not wholly ignore approved mercantile custom; that they must adapt their rules to such customs; that in fact there were cases in which [the banking community] must be allowed to give laws to Westminster Hall”.

The legislature has recently shown the same willingness to uphold the customs and practices of CCP systems. It will be demonstrated below that the House of Lords decision in British Eagle ignored the practices of the clearing members of the IATA CCP system and that

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94 2 Ld. Raym 757 (Eng.).
95 Supra note 93.
96 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 176 (Vol. VIII, Methuen Subjects, London). Westminster Hall consists of the House of Lords (now the Supreme Court of the U.K.) and House of Commons.
the case was decided contrary to their business needs. Consequently, the English Legislature introduced Part VII of the Companies Act 1989 to reverse British Eagle, since the decision was destructive to the operations of CCP systems.

(b) Banking Practice as a Source of the Clearing Rules

The clearing rules reflect the customs, practices and usages of a clearing system in written form. In other words, the clearing rules are an objective manifestation of those practices, and they provide clarity and legal certainty for the members of a clearing arrangement, who are contractually bound by those rules. The case law has demonstrated that the rules of an exchange or a clearing house reflect the practices of these institutions. By analogy, the clearing rules of a CCP should reflect their practices, and it is common for the clearing rules to expressly provide that the participants are subject to CCP customs and practices.

Johanna Vroegop analyses the importance of banking practice in the context of cheque clearing houses in her article ‘The Legal Implications of Cheque Truncation’. She demonstrates that banking practice has traditionally played an important part in the decisions of the courts. This is particularly relevant where a clearing system is concerned, since the banks involved will have agreed on clearing procedures and worked out a set of rules to determine any matters at issue between them.

98 Tayeb v. HSBC Bank, [2005] 1 C.L.C. 866 (C.C.) (Eng.). This case dealt with the U.K. CHAPS clearing system.
99 For example, the SIX Swiss Exchange (which clears with Eurex) General Conditions provide in Condition 5 (4 May 2009) that “the customs and usages describe the “standard contract” between participants for transactions which are subject to clearing through a SIX Swiss Exchange-recognized CCP. All Transactions, for which one of the SIX Swiss Exchange-recognized CCPs becomes a contracting party, are subject basically to the rules of the respective CCP, in particular but not limited to the rules on the formation of contracts, on the performance and non-performance”. Emphasis added.
100 Johanna Vroegop, The Legal Implications of Cheque Truncation, LMCLQ 244, 247 (1990).
The courts have generally accepted clearing house rules as determining issues before them. The practices of CCPs have been enforced by the courts as implied terms forming part of the clearing rules. All the system participants, including the direct clearing members and the indirect non-clearing members, are bound by the clearing rules, whether or not they were aware\(^{101}\) of them, as long as the practice is proven to be certain, notorious and reasonable.\(^{102}\)

The importance which is given to the practices of CCPs systems was demonstrated after the *British Eagle* decision. The House of Lords decision ignored the practices of the IATA CCP system by strictly applying the relevant corporate insolvency legislation and finding that the clearing rules were not binding against a liquidator after a clearing member insolvency had commenced. The decision has since been statutorily reversed for financial market CCPs with the introduction of carve-out statutes, which protect clearing system rules from domestic corporate insolvency laws. The decision has arguably also been reversed for non-financial market CCPs by the courts in *Ansett*, which suggests that the CCP rules are enforceable against a liquidator in an insolvency situation as long as the clearing rules are appropriately drafted.

\(^{101}\) “A party to a contract is bound by usages applicable to it as certain, notorious and reasonable, although not known to him. If the practice, though certain and notorious, is unreasonable, it of course follows that it cannot constitute a usage which the court will enforce as a usage. Nevertheless if a party knows of such a practice and agrees to it, then though unreasonable, he is bound by it” (emphasis added); *Cunliffe-Owen, supra* note 73, at 1439. This means that clearing members (and non-clearing members) are bound by the usages of CCPs that meet the above criteria, even though they may not have “knowledge” of these usages. Nevertheless, it is unlikely that a clearing member would not be aware of a particular custom or practice.

\(^{102}\) *Id.*
(c) **A Comparative Analysis**

(i) **English Position**

In England, the courts have found the clearing system rules to be binding on participants in several cases.\(^\text{103}\) In *Hare v. Henty*,\(^\text{104}\) the clearing house rules determined the reasonable time for ‘presentment’ of a cheque. In *Re Farrow’s Bank Ltd.*,\(^\text{105}\) the clearing house members considered the time of payment. More recently, in *Tayeb v. HSBC Bank*,\(^\text{106}\) the commercial court recognized the important role that banking practice plays in formulating the rules of a clearing system. The court held that the clearing house customers were bound by a clearing rule determining payment finality, despite having had no hand in formulating the rule and whose existence they were probably unaware of. The court held that the contractual arrangements which make up the rules of the Clearing House Automated Payments System (CHAPS) clearing system for electronic funds transfers in England are binding on the system members and participants, determining their rights and obligations, and determining when finality of a transaction occurs.

Furthermore, the bank and the customer were held to be bound by the implied practices of the banking community with regard to the clearing house rules. The CHAPS clearing rules determined the time of payment countermand so that a completed CHAPS payment was deemed to be irrevocable and final by the system participants. The clearing house rules determined the point in time that a payment became final in the clearing system, thereby prohibiting the payee bank from reversing a credit entry made into his customer’s (the payee’s) account.\(^\text{107}\)

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\(^{103}\) See *Parr’s Bank Ltd. v. Thomas Ashby & Co.*, (1898) 14 T.L.R. 563 (Eng.), where the clearing house rules determined the question at issue.

\(^{104}\) (1861), 10 C.B.N.S. 65 (Eng.).

\(^{105}\) [1923] 1 Ch. 41 (Eng.).

\(^{106}\) Supra note 98.

\(^{107}\) It is interesting to note that the practice in question worked to the advantage of the customer even though they did not have knowledge of it. It is also safe to suggest that after the *Cunliffe-Owen* decision, the above-mentioned practice would not have been binding on the customer if it had operated unreasonably to the detriment of the
The *British Eagle* is a major exception to the rule. The House of Lords did not allow the clearing arrangement to contract out of the U.K. corporate insolvency statute. Nevertheless, this case was statutorily reversed because it conflicted with the public policy of promoting safe and efficient financial markets.

**(ii) Australasian Position**

In Australia, the court in *Riedell v. Commercial Bank of Australia*[^109] held that the clearing house rules determined the amount of time allowed for a drawee bank to decide whether to accept and make payment on a presented cheque, or to reject payment and return the cheque. Mann J. held that “the rules of the clearing house required, and the practice conformed to the rules, that settlement of daily balances so disclosed would be made through the Commonwealth Bank at the first clearing the following morning.” Furthermore, his Honor stated that the clearing house rules:

> “have been approved by all the banks and have been revised from time to time, though at long intervals. They deal in detail with the whole process of clearing, and constitute … an agreement between the banks, some provisions of which lay down rules of imperfect obligation, while others may fairly be regarded as intended to define legal rights and duties in relation to the daily business of the parties concurring in them. Apart from the contractual aspect, the rules afford the best evidence of the established practice of bankers within the field of banking operations covered by them.”

Therefore, the clearing rules will usually reflect the practices of clearing systems. Since the time of payment finality was neither codified nor stated in the case law, the courts will look at the customs and practices of the banking community to answer legal questions in order to attain legal certainty.

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[^108]: The U.K. *Companies Act* 1948.
Furthermore, a customer may not be bound by the clearing rules or practices if they are deemed to be unreasonable by the courts.

“The plaintiff [customer] could not complain of any delays involved in the clearing house practice, because he must be held to have contracted with the bank with that well-known practice in view. On the other hand, he was entitled as between himself and his agent [bank] to have the benefit of any advantages arising from the use of the machinery of the clearing house”. 110

This passage suggests that a customer will be bound by a particular practice if it is notorious, notwithstanding that the practice is deemed unreasonable, provided the customer has contracted and agreed to be bound by those implied terms. This is consistent with the decision in Cunliffe-Owen.

A New Zealand court in H.H. Dimond Ltd. v. Australia and New Zealand Banking Group Ltd., 111 in a case making a distinction between banking practice and the clearing house rules, held that banking practice, rather than the clearing house rules, determined the issue in question. It is questioned whether this case is an authority for the proposition that banking practice can override the clearing rules if they are inconsistent with each other. 112 This would be an unlikely scenario, since the clearing rules are generally created and amended by its members.

Furthermore, the Australian High Court decision in IATA v. Ansett suggests that the rules of a CCP system go so far as to supersede conflicting corporate insolvency laws, as will be discussed below.

110 Emphasis added.
112 Joanna Vroegop argues that the binding force which the common law courts give to clearing house rules is “based on the traditional importance of banking practice, rather than on their nature as clearing house rules”. In other words, the courts view banking practice as more indicative of the nature of the parties’ intentions than the clearing rules. Supra note 100.
(iii) **U.S. Position**

In the United States, the Uniform Commercial Code (U.C.C.) states that the “clearing house rules … have the effect of agreements … whether or not assented to by all parties”.\(^{113}\) Furthermore, the court in *West Side Bank v. Marine National Exchange*\(^ {114}\) held that the dishonoring of a cheque had taken place within the time allowed by the clearing house rules. Notwithstanding this judicial decision and the U.C.C. provision, the judgment concludes that the clearing house rules can supersede any inconsistent parts of the U.C.C, since the Code allows its provisions to be varied by agreement.\(^ {115}\) Therefore, the clearing rules can supersede or take precedence over the U.C.C.

(iv) **Canadian Position**

In Canada, the courts have determined that the cheque clearing house rules are binding on its participants. The Canadian Payments Association (CPA)\(^ {116}\) is authorized to “make such rules respecting clearing arrangements and the settlement of payment items”.\(^ {117}\) The question before the courts has often been whether cheque clearing house rules determine the finality of payment, which provides legal certainty to the payee that payment has been made, and it provides legal certainty to the drawer that it has been discharged.

In *National Slag v. Canadian Imperial Bank of Commerce*\(^ {118}\) it was held that a cheque had been dishonored by the drawee bank after the expiry of the time allowed by the clearing house rules. The judgment accepted the clearing house rules as determining the time within

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\(^{113}\) U.C.C. §4-103 (b). The Canadian position is different, as will be seen below.  
\(^{114}\) (1968) 155 N.W.2d 587.  
\(^{115}\) Id., per Heffernan J., at 593-595.  
\(^{116}\) The CPA is a not-for-profit organization that develops the policies and rules that support the safety and soundness, efficiency, accessibility and innovation in Canada’s payments systems.  
\(^{117}\) Canadian Payment Association Act 1985, R.S.C., ss. 5 and 19 (1).  
\(^{118}\) (1982), 140 D.L.R. 3d 473 (Can.).
which the drawee bank had to act. In other words, the clearing house rules, which specified the time limits as to the return of dishonored cheques by the drawee bank to the negotiating bank in the clearing system, were binding on the system participants. Furthermore, a breach of the clearing rules entitled the injured party to damages.

However, notwithstanding the binding force of the clearing house rules on the system participants in ordinary circumstances, the depositary bank was protected in this case by an account agreement\(^\text{119}\) which allowed the bank to debit the customer’s account for all returned items, thereby contravening the clearing rules. The court held that the account agreement “entitled [the depositary bank] to debit the appellant’s [customer] account, even though the cheque was returned in a manner not strictly in accord with the clearing house rules”. Therefore, the Canadian courts may allow a contractual arrangement to overrule the binding force of the clearing rules if the system participants enter into an alternative contractual agreement that falls outside the clearing arrangement altogether. This decision ultimately undermines the binding force of clearing system rules.

The court in *Bank of Montreal v. Johansen*\(^\text{120}\) further undermined the binding force of the clearing house rules by holding that regardless of compliance or noncompliance with clearing rules and irrespective of whether a customer may benefit from a clearing rule, a drawee bank that makes a representation as to the occurrence of “payment” may be estopped from denying it. Furthermore, the court in *National Bank of Greece (Canada) v. Canada Permanent Trust Co.*\(^\text{121}\) held that the clearing system participants treated the clearing rules, which were created by the


\(^{120}\) (26 Nov. 1986) (B.C. Co. Ct.) [unreported] (Can.).

\(^{121}\) [1987] R.J.Q. 607 (Que. Sup. Ct.) (Can.).
CPA, as forming an inter-institution binding contract that set standards and conferred rights and obligations for and on member institutions.

Unlike the U.S. and English positions, it was suggested in *Sterling Bank of Canada v. Laughlin* that the clearing house rules are not binding on indirect system participants, i.e. non-clearing members. However, it is submitted that both the direct and indirect system participants will be deemed by the courts to be bound by the usage of the clearing system. It was stated by the court in *Sterling* that “the dealings sanctioned as between the banks by the voluntary association in the clearing-house system … is a matter not binding per se on the public unless it can be assumed or proved that the party sought to be charged has been dealing with the bank subject to the usage of the clearing house.” Both the clearing members and the non-clearing members will usually be held to be subject to the usage of the clearing system; therefore, they will be bound by the rules of a particular clearing system.

(d) **Customs and Practices as Implied Terms**

The enforcement of customs and practices through implied terms remains particularly important for both non-financial market CCPs and financial market CCPs, notwithstanding that these practices may have been given statutory codification in the latter context. The recognition by the courts of customs and practices through implied terms is necessary so that CCP systems have the necessary contractual freedom to bypass burdensome insolvency laws and maximize legal certainty.

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122 (1912) 1 D.L.R. 383 (Ont. Div. Ct.) (Can.).
123 Id. at 384.
124 Professor Dalhuisen has stated that the force of custom has been more readily accepted internationally on the basis of implied terms. See DALHUISEN, *supra* note 35.
Firstly, the English Court of Appeal in *Joachimson v. Swiss Banking Corp.*\(^{125}\) held that implied terms include customs and usages,\(^{126}\) and the judges identified a number of key terms which were to be implied into the bank-customer contract because of the nature of the relationship.\(^{127}\) In *Produce Brokers C., Ltd. Appellants v. Olympia Oil and Cake Company*,\(^{128}\) the House of Lords discussed the relevant English authorities which support the view that customs and usages may be imported into mercantile contracts as implied terms, and held that a custom can be incorporated into a contract where a position in the contract is silent,\(^{129}\) unless the custom has been expressly excluded in the contract.\(^{130}\)

In *Tournier v. National Provincial and Union Bank of England*,\(^{131}\) the court held that a bank’s duty of secrecy is an implied term of bank-customer contract. Atkin L.J. stated that “the

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\(^{125}\) [1921] 3 K.B. 110 (Eng.).

\(^{126}\) ‘Usage’ as an implied term was allowed in *Cunliffe*, which held that “‘usage’ may be admitted to explain the language used in a written contract or to add an implied incident to it, provided that if expressed in the written contract it would not make its terms or its tenor insensible or inconsistent”, *supra* note 73, at 1438. Also, Erle C.J. in *Meyer v. Dresser*, (1864) 16 Common Bench Reports (New Series) 646 143 E.R. 1280 (Eng.), stated that “in the cases where such local usages are imported into a contract, it is because they tacitly form part of it, like those contracts in which we find the words ‘and other usual terms.’ They then form part of the contract itself. The contract expresses what is peculiar to the bargain between the parties, and the usage supplies the rest”, at 660. Emphasis added.

\(^{127}\) In the absence of statutory provisions, the courts will imply a term into a contract (1) where the term is necessary to give business efficacy to the contract, (2) where the term was so obviously a stipulation in the agreement that it goes without saying that the parties must have intended it to form part of their contract, (3) where the term has become standardized in a particular type of contract, and (4) where the term is implied by the custom of a locality or the usage of a particular trade. See *Joachimson*, Atkin and Bankes L.J.J., *supra* note 125; see SEALY & HOOLEY, *supra* note 91, at 594.


\(^{129}\) Parke B. in *Hutton v. Warren*, (1836) 150 E.R. 517 at 475, confirmed “that, in commercial transactions, extrinsic evidence of custom and usage is admissible to annex incidents to written contracts, in matters with respect to which they are silent ... and this has been done upon the principle of presumption that, in such transactions, the parties did not mean to express in writing the whole of the contract by which they intended to be bound, but a contract with reference to those known usages”. Emphasis added.

\(^{130}\) Parke B. in *Metzner v. Bolton*, (1854) 9 Ex. 518, 521 at 325, stated that “it is quite certain that general usages are tacitly annexed to all contracts relating to the business with reference to which they are made, unless the terms of such contracts expressly or impliedly exclude them”. Emphasis added. Refer to Lord Blackburn in *Tucker v. Linger* (1882-83), L.R. 8 App. Cas. 508 at 511.

\(^{131}\) [1924] 1 K.B. 461 (Eng.).
question of what terms are to be implied in a contract is a question of law”, 132 and cited Scrutton L.J. in In re Comptoir Commercial Anversois and Power:

“The Court … are the tribunal to find such a term; they ought not to imply a term merely because it would be a reasonable term to include if the parties had thought about the matter, or because one party, if he had thought about the matter, would not have made the contract unless the term was included; it must be such a necessary term that both parties must have intended that it should be a term of the contract, and have only not expressed it because its necessity was so obvious that it was taken for granted”. 133

Therefore, a particular custom, practice or usage becomes an implied term when it was ‘intended’ between the parties as necessary for the contract to operate.

In support of this approach, the court in Shearson Lehman134 found that it was necessary to imply a term into the rules of London Metal Exchange (LME) derivatives exchange. This gave the LME the power to suspend all dealings on the exchange upon the occurrence of an event which would otherwise have been destructive to business on the exchange.

In light of the role of banking practice and implied terms, the court should first look at the clearing rules to determine whether any customs and usages have been expressly included or excluded in the clearing rules of a particular CCP. Secondly, the court should look at the customs and practices of CCPs for guidance where there is a gap or uncertainty in the clearing rules and incorporate them through implied terms. The correct starting point is the RCCP, which is a manual containing the observed practices of CCPs. These have been documented and compiled by the IOSCO-CPSS for all CCPs to observe and follow. It would be prudent for the courts to adhere to the recommendations and the core principles contained therein by recognizing them as implied terms of all CCP arrangements.

132 At 483.
134 Supra note 88, at 586.
(e) **Customs and Practices versus Statutes**

The main question for commercial lawyers is whether new customs and practices can overturn conflicting statutory law. It is submitted that the answer will depend on the policy behind the particular statute or statutory provision in question. The lex mercatoria has been recognized by the common law courts as a valid source of law in order to pursue a policy that promotes the efficiency of markets, and the economy in general. It is recognized by the courts that merchants are in the best position to decide which customs and practices best suit their business needs. It has been the role of the law to recognize and give judicial force to those customs and practices.

It was held by Cockburn C.J. in *Goodwin v. Robarts* that “we must by no means be understood as saying that mercantile *usage*, however extensive, should be allowed to *prevail if contrary to positive law* ... To give effect to a usage which involves a defiance or disregard of the law would be obviously contrary to a fundamental principle”.\(^{135}\) It has been considered heresy in common law jurisdictions to suggest that the common law courts can override a conflicting statutory position. It is the legislature’s job to repeal and replace statutes that reflect antiquated policies. However, this statement is based on an understanding of the law in terms ‘legal positivist’ thinking, which views the law as statist.

It is preferable to view the commercial law in light of the ‘natural law’ school of thought, which views the law as dynamic and based on principles of natural justice. Contrary to the position of Cockburn C.J., the customs and practices of financial market CCPs have been codified by special financial markets legislation. These carve-out statutes have the dual objective of (1) conferring statutory force on the policies reflected in the customs and practices of CCPs

\(^{135}\) *Supra* note 20, at 357. Emphasis added.
and (2) allowing CCP operations to supersede and override corporate insolvency laws which may conflict with their risk management functions. Therefore, it is argued that the new transnational lex mercatoria should also be able to supersede conflicting statutory law.

6. THE CODIFICATION OF THE LEX MERCATORIA

There are two key examples of situations concerning commercial law matters where the legislature of a common law country has intervened to give statutory force to the lex mercatoria through codification. In both cases, the legislature had recognized a particular and well-established custom, practice or usage of a particular group of merchants, where the court was unwilling to do so. Firstly, in Clerke v. Martin, the court was unwilling to recognize a usage of bankers which treated promissory notes as “negotiable” instruments. The U.K. legislature recognized the importance of this particular usage and codified it in the Promissory Notes Act 1704.

Secondly, in British Eagle, the House of Lords failed to recognize a practice which was notorious among CCP systems. The CCP alleged that their main risk management practice was to perform multilateral insolvency set-off upon the insolvency of one of the clearing members. This process involved reducing all the clearing member’s gross obligations to a single net claim either owed to or owed by the CCP. However, the court did not recognize this practice because the “mutuality” requirement was not satisfied on the insolvency date. In other words, counterparty substitution had not yet occurred on the date of the clearing member insolvency. A practice allowing counterparty substitution on the insolvency date conflicted with the corporate insolvency laws of the time. Therefore, the U.K. Parliament introduced Part VII of the

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136 This process is often referred to as ‘multilateral novation netting’. However, it is more accurate to describe the clearing process as ‘multilateral set-off’ in the context of the IATA clearing arrangement, since IATA cleared debts, and not executory contracts. See supra note 6.
Companies Act 1989, which codified this practice. It is essential for a CCP to be able to perform multilateral insolvency set-off upon the insolvency of a clearing member as a part of its risk management operations.

(a) **Examples of the Lex Mercatoria Superseding Conflicting Statutory Law**

A further question is whether custom may be subject to strong policy considerations contained in statutes. Professor Dalhuisen argues that “on its face that would seem so, but if a practice or custom continues notwithstanding contrary statutory law, it may be considered to have overturned it”.\(^\text{137}\) It is argued that CCP customs and practices have overturned the *pari passu* policy contained in the corporate insolvency laws of many jurisdictions. The lex mercatoria in the form of case law can supersede statutes if they are not frequently updated.\(^\text{138}\)

(i) **Example 1: Demand of Payment at Bank Branch**

In Canada, banking practice has superseded a redundant statutory provision which requires bank customers to demand payment of their deposits at the branch where the account is kept. It is clear from the landmark decision of *Joachimson v. Swiss Bank Corp.*\(^\text{139}\) that a customer must demand payment from his bank for money deposited in a bank account at the branch where the account is kept. Atkin L.J. stated that:

“payment can only be due ... at the *branch where the account is kept*, and where the precise liabilities are known. And if this is so, I apprehend that *demand* at the place where alone the money is payable must be necessary. A decision to the contrary would subvert *banking business*”.\(^\text{140}\)

\(^{137}\) See Dalhuisen, *Lex Mercatoria*, supra note 19, at 163, fn. 60.

\(^{138}\) Professor Dalhuisen has expressed that “statutory private law is therefore not public policy *per se*, and does not on that score automatically prevail over the international legal order and its laws in situations properly governed by them”. *Id.* at 176.

\(^{139}\) *Supra* note 119.

\(^{140}\) Emphasis added.
In Canada, this ratio was codified in section 461 (2) of the Bank Act 1991, which states that:

The amount of any debt owing by a bank by reason of a deposit in a deposit account in the bank is payable to the person entitled thereto only at the branch of account and the person entitled thereto is not entitled to demand payment or to be paid at any other branch of the bank.¹⁴¹

Notwithstanding this statutory provision, there is persuasive academic and judicial authority which suggests that modern banking practice has overridden the requirement for demanding payment at the branch where the account is kept in order to meet modern business needs. Ellinger’s Modern Banking Law¹⁴² cites the Singaporean case of Damayanti Kantilal Doshi v. Indian Bank¹⁴³ as an authority for the proposition that banks probably waive the requirement of demand for payment at the branch of account.

This is a modern example of the lex mercatoria superseding an outdated statutory provision. It is understandable that there used to be a requirement for demanding payment at the branch where the account is kept in the period before electronic banking. However, electronic banking has allowed banks to change their practices in order to better suit their customers’ needs. It means that customers can demand payment at any branch belonging to their bank, since account information can be instantly shared and accessed electronically across banking networks. The introduction of Automated Teller Machines (ATMs) means that a customer can demand payment at any terminal of any bank that is linked up to that customer’s bank account.¹⁴⁴ Therefore, the lex mercatoria is able to supersede statutory provisions which are redundant.

¹⁴¹ Emphasis added.
¹⁴³ [1999] 4 S.L.R. 1 (Sing.).
¹⁴⁴ E.g. most bank ATMs are linked by Interac in Canada.
(ii) **Example 2: The Ansett Decision**

It is argued that the Australian High Court decision in *IATA v. Ansett* allowed a CCP’s customs and practices to supersede a conflicting statutory provision. This case dealt with a CCP system for the airline industry – the IATA clearing system. One of the clearing members (Ansett) became insolvent, and the CCP wanted to perform multilateral insolvency set-off after the clearing member began insolvency proceedings. Multilateral insolvency set-off intended to produce a new net claim in order to facilitate the settlement of the outstanding claims between Ansett and IATA. Ansett’s liquidator argued that this was not possible because counterparty substitution had not occurred and the mutuality requirement in the Australian Corporations Act 2001 was not satisfied. This meant that the CCP could not perform multilateral insolvency set-off.

Nevertheless, the High Court held that the CCP system was allowed to perform the multilateral insolvency set-off, presumably because the clearing arrangement satisfied the requirements of the statute. Although the judges were not clear in how they reached their decision, the outcome suggests that the judges implicitly recognized a practice called ‘open offer’. Some CCP systems use open offer as a method of counterparty substitution in order to guarantee the satisfaction of the mutuality requirement.

This practice was developed by CCPs in order to protect themselves from corporate insolvency laws, especially in common law countries. After the *British Eagle* decision, which also dealt with the IATA CCP, the legislatures of several jurisdictions recognized that the customs and practices of CCPs were crucial for them to properly perform their risk management functions. They received statutory recognition in the context of financial market CCPs.

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146 *British Eagle* dealt with a previous version of the IATA clearing arrangement, which had slightly modified clearing rules.
However, non-financial market CCPs have not been given the same protection, and the *Ansett* decision suggests that the common law courts are willing to adhere to customs and practices of non-financial market CCPs to provide them with the same protections afforded to financial market CCPs. The decision goes so far as to suggest that the courts will allow these practices to supersede conflicting corporate insolvency laws. Therefore, the new transnational lex mercatoria steps in to protect CCP operations where specific legislation has failed to do so.

### 7. THE LEGAL NATURE OF THE LEX MERCATORIA: DOCTRINAL ISSUES

An important academic question is whether the new transnational lex mercatoria is (1) an *independent source* of law which remains separate from the domestic legal system and operates by superseding conflicting domestic laws, or (2) whether it is a source of law which is *integrated* into domestic legal systems. There has been some academic discussion in the context of the law merchant. Professor Dalhuisen would argue in favor of the former view, whereas Professor Rogers would argue in favor of the latter.

**(a) An Independent Source of Law**

The bed-rock case of *Goodwin v. Robarts* envisioned the lex mercatoria as an independent source of law.

> “The law merchant is sometimes spoken of as a fixed body of law forming part of the common law, and as if it were coeval with it. But as a matter of legal history, this view is altogether incorrect. The law of merchant, ... though forming part of the lex mercatoria is of comparatively recent origin. It is neither more nor less than the usages of merchants and traders in the different departments of trade, ratified by the decisions of Courts of law with a view to the interests of trade and public convenience”.\(^{147}\)

\(^{147}\) *Supra* note 20, at 346.
In support of this view, Professor Dalhuisen convincingly argues that “international business is likely to be better served by the appropriate transnational law, even if it is less detailed, than it would be by the wrong domestic law, even if that domestic law is thought to bring greater certainty within its own territory”. This argument suggests that transnational customs and practices may supersede conflicting or outdated domestic laws. However, the ability for CCP systems to do this must not go unchecked, and CCPs should not be able to supersede or contract out of domestic laws which impose minimum regulatory safeguards on financial and banking systems, since some of these systems are of systemic importance.

(b) An Integrated Source of Law

On the other hand, Professor Rogers argues in his work on ‘The Early History of the Law of Bills and Notes: A Study of the Origins of Anglo-American Commercial Law’, that “the law merchant … is part of the common law”. This work considers the nature of the law merchant in the context of negotiable instruments. He argues that:

“the usual assumption that merchants shunned the common law is inaccurate … The traditional account of early English commercial law [states] that mercantile disputes were governed by a distinct body of law known as the law merchant, administered in specialized mercantile courts. In the standard accounts of the history of commercial law, the law merchant is usually taken to have been a body of substantive law based on mercantile custom, distinct from the common law applied in the central courts. Although this view has won nearly universal acceptance among writers on commercial law, the evidence shows that it is quite inaccurate”.

“The whole point of the establishment of the mercantile courts is supposed to have been that the common law courts would not recognize the law merchant. In fact, however, the central courts did hear disputes concerning the law merchant and even applied law merchant procedure and rules in mercantile cases”.

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148 At 189. Emphasis added.
149 Supra note 92.
150 Id. at 250.
151 Id. at 20.
152 Id. at 27.
His arguments are supported by J.H. Baker, who has shown that the common law courts regularly dealt with commercial matters from the earliest times. Professor Rogers suggests that “not only did the central courts hear cases involving merchants; they also took account of the special needs of commerce in the development and application of legal rules”.

(c) The Lex Mercatoria in Practice

The views of both Professors Dalhuisen and Rogers are reflected in the case law. It is argued that the House of Lords decision in British Eagle is an example of the court treating the lex mercatoria as being integrated into the common law. This supports Professor Roger’s view.

Their Lordships recognized the possibility that there might be a CCP practice which allowed for insolvency set-off without mutuality. However, this practice was not proven. Even if the practice had been established, it could not override a conflicting statutory provision contained in the corporate insolvency laws. The decision suggests that the court treated the lex mercatoria as part of the common law. It was doctrinally sound for the House of Lord to prohibit the common law from overriding a conflicting statutory provision. Consequently, the English legislature had to intervene to remedy the situation by introducing Part VII of the Companies Act 1989.

In support of Professor Dalhuisen’s view, it is argued that the Ansett decision allowed the practices of the CCP system to operate notwithstanding the existence of a conflicting statutory provision contained in the Australian corporate insolvency legislation. This suggests that the lex

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154 Id. at 17.
155 The pari passu principle.
mercatoria and the common law were treated as *separate* sources of law, thereby allowing the lex mercatoria to supersede or be exempted from the conflicting statutory provisions.

In light of this evidence, it is argued that the lex mercatoria should be treated as a separate source of law, since it is the most practical and efficient approach for satisfying the business needs of the mercantile community. Professor Roger’s view is less dynamic, and it does not adequately protect CCP arrangements from outdated statutory provisions, as was demonstrated in the *British Eagle* decision. Dalhuisen’s view provides a speedy solution which can be achieved at the court level, as was demonstrated in the *Ansett* decision. The financial markets require that the courts or arbitrators provide them with speedy and reliable solutions.

Therefore, treating the new transnational lex mercatoria as a separate source of law with its own legal force is preferred, since it recognizes the ‘transnational’ aspect of this source of law. Treating the lex mercatoria as forming part of the common law is redundant in the context of a ‘transnational’ legal regime which encompasses a multitude of different legal systems.

(d) **The New Transnational Lex Mercatoria is Compatible with Public Policy Goals**

The customs and practices of CCP systems have allowed them to achieve bankruptcy resistance and develop risk management tools such as contractual netting schemes, collateral arrangements, etc. These indirectly promote the public interest by enhancing legal certainty and efficiency of the financial markets. Legal certainty reduces the chances of systemic risk during

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156 Although it is recognized that the appeal process in both the *British Eagle* and *Ansett* decisions went on for several years until they reached the House of Lords and the High Court.


158 I.e. civil law and common law systems.
periods of financial market turbulence. Therefore, these customs and practices should be allowed to supersede conflicting statutory policies even if they are not codified.

8. **LEGISLATION GOVERNING FINANCIAL MARKET CCP ARRANGEMENTS**

Statutory carve-outs are designed to protect multilateral netting and collateral arrangements in the event of a clearing member insolvency. The CCP arrangement should take precedence over insolvency procedures.\(^{159}\) It is submitted that the new transnational lex mercatoria and the carve-out statutes are fully compatible with each other. The carve-outs implicitly, and sometimes expressly, state that the customs and practices of CCP systems are the main sources of law governing their arrangements. The clearing rules are the main source, and these encompass the observable customs and practices of CCPs.

However, determining the legal effect of these statutes can be complicated for lawyers. The statutory and regulatory sources of the jurisdictions below will demonstrate that the current legal regimes are composed of a plethora of scattered legal sources which need to be pieced together in a piecemeal fashion in order to determine their effect. The matter is not helped by the fact that these sources are often outdated\(^{160}\) and do not always cross-reference newer or complimentary sources of law. The new transnational lex mercatoria has emerged as source of law in response to the current state uncertainty. It aims to provide legal clarity for both financial and non-financial market CCP systems, especially for CCPs with cross-border operations.

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\(^{159}\) The *Companies Act*, 1989, s. 159.

\(^{160}\) E.g., the English *Companies Act* is from 1989.
This new Regulation is compatible with the new transnational lex mercatoria, although the introduction of minimum regulatory standards means that CCPs may have lost some of the freedom they previously had. The Regulation was drafted by the E.C. Commission to, *inter alia*, “introduce a mandatory requirement directed to all actors to clear standardized OTC derivatives through CCPs and to ensure that CCPs, that will as a consequence assume and concentrate significant risk, are subject to uniform prudential standards in the E.U.” The Regulation only applies to financial market CCPs, and it does not cover non-financial market CCPs, which are governed by the new transnational lex mercatoria.

Since there will be an obligation to clear all “standardized OTC derivatives” through CCPs, the European Commission and European Securities and Markets Authority (ESMA) have assumed new powers to regulate, supervise and oversee the activities of CCP systems and their domestic Member State regulators.

The Regulation recognizes that forcing CCPs to clear OTC contracts that they are unable to risk-manage may have adverse repercussions on the stability of a particular CCP system. Therefore, the Regulation introduces two approaches to determine which contracts require mandatory clearing. In the ‘bottom-up’ approach, a CCP decides to clear certain contracts and is authorized to do so by its competent authority, who is then obliged to inform ESMA once it approves the CCP to clear those contracts. In the ‘top-down’ approach, the ESMA and European

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162 A ‘CCP’ is defined as “an entity that legally interposes itself between the counterparties to the contracts traded with one or more financial markets, becoming the buyer to every seller and the seller to every buyer and which is responsible for the operation of a clearing system”. Emphasis added. At art. 2 (1).
Systemic Risk Board, will determine which contracts should potentially be subject to the clearing obligation.163

The Commission argues that both approaches are necessary because the G-20 clearing commitment164 cannot be left entirely to the initiative of the industry. This argument is convincing, and a balanced approach will help achieve the goals of the Regulation. On the one hand, the ‘bottom-up’ approach is compatible with the new transnational lex mercatoria, since it allows CCPs to take the initiative in clearing the contracts that it wants to clear. This allows a CCP to run its own affairs according to its business needs. The Regulation has given CCPs some contractual freedom to develop their customs and practices. This policy recognizes that CCPs have rarely failed in the past,165 and unlike other financial institutions, the role of CCPs is to manage risk.

On the other hand, the ‘top-down’ approach ensures that the regulators monitor the clearing activities of CCPs, which may become riskier as they assume more risk from clearing increasing amounts of OTC contracts. Regulators require regulatory powers in order to control the operations of CCP systems, which will increasingly have the potential to cause systemic risk. It is ESMA’s job to ensure that CCPs clear certain standardized OTC contracts to increase transparency and mitigate counterparty risk and to ensure that they are not forced to clear contracts that they cannot handle.

Under the new legislation, the customs and practices of CCP systems will still be adhered to and recognized as legally binding by ESMA, the domestic Member State regulatory authorities, and the Member State courts. The Regulation expressly states that it follows the

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163 Explanatory Memorandum, at para. 4.3.2.
164 Guidelines for shifting standardized OTC contracts onto CCPs were drafted at the G-20 Pittsburgh Summit 2009.
165 Supra note 1.
Recommendations published by the CPSS-IOSCO, the European System of Central Banks and the Committee of European Securities Regulators (ESCB-CESR) to create a framework in which CCPs can operate safely. ESMA should consider these developments when developing the regulatory technical standards. Since the CPSS-IOSCO Recommendations are a codification of the observed customs and practices of CCP systems, the Regulation effectively recognizes the new transnational lex mercatoria as a valid source of law. This is a sensible approach, since CCPs have proven to be in the best position to develop their own customs and practices.

(ii) E.C. Directives


(A) Settlement Finality Directive 1998

Under the Settlement Finality Directive, netting agreements entered into by “CCP systems” operating in the E.U. continue to operate when a clearing member becomes insolvent, since the claims involved are huge. Netting agreements have priority over local insolvency laws as long as the netting occurs before the commencement of insolvency.

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166 Preamble, at para. 49.
167 These Directives required each Member State to implement them into their domestic law. E.g., the Settlement Finality Directive has been implemented in the U.K. as The Financial Markets and Insolvency (Settlement Finality) Regulations, 1999 (S.I. 1999 No. 2979). The Collateral Directive was implemented as The Financial Collateral Arrangements (No.2) Regulations, 2003 (No. 3226).
169 Art. 2(a).
170 This supports a pro-creditor public policy approach.
proceedings, or the netting occurs after the opening of insolvency proceedings without the CCP’s knowledge.\textsuperscript{171} This Directive remains functional under the E.C. Regulation on CCPs.\textsuperscript{172}

**(B) Collateral Directive 2002\textsuperscript{173}**

The purpose of using collateral as margin is to secure the obligations of the parties to financial derivatives so that the counterparties can set-off the collateral in the margin accounts on a daily basis,\textsuperscript{174} which reduces the amount of capital needed to be posted to a net amount. Daily settlement means that the ‘net net debtor’ will make a single net payment to the ‘net net creditor’ to settle all the claims.

If netting agreements are invalidated, collateral arrangements suffer the risk of being recharacterized as security interests that would normally be void for failure to comply with formalities. Therefore, the Collateral Directive specifically validates the netting of collateral. Margin consists of “personal collateral”\textsuperscript{175} involving a “full transfer of ownership”\textsuperscript{176} of assets from the counterparty with a contractual (personal) obligation to re-transfer assets of like kind or of an equivalent value. The transfer of ownership is crucial in CCP systems so that the CCP can realize the collateral as its own without being challenged by a defaulter’s liquidator.

\textsuperscript{171} Art. 3(1), actual or constructive “awareness”.
\textsuperscript{172} Preamble, at para. 29.
\textsuperscript{174} This operation is known as ‘marking-to-market’.
\textsuperscript{176} Art. 2, CD2002.
(b) **England**\textsuperscript{177}

(i) **The Companies Act 1989**\textsuperscript{178}

Part VII deals with Financial Markets and Insolvency. It exempts market contracts, market charges, money market contracts, money market charges, and system charges from insolvency laws. It safeguards the operations of certain financial markets with respect to insolvency, winding up, default, the enforcement of charges, and margin.\textsuperscript{179} CCP clearing arrangements are expressly protected under this part of the Act as Recognized Clearing Houses (RCH), and are regulated by the Financial Services Authority (FSA).\textsuperscript{180} Its effect was also to reverse the effects of the *British Eagle* decision and give effect to the minorities’ judgment.

According to Professor P.R. Wood, Part VII was:

“enacted to reduce the possibility of domino insolvencies occurring by enhancing the effect of the techniques employed by the market of netting out exposures to defaulting counterparties, by protecting margin and protecting security given to support the obligations of market participants ... Its main effect was to reverse certain changes to 1986 insolvency freezes on security in the event of a rehabilitative administration. There are various implementing regulations”.\textsuperscript{181}

Therefore, clearing houses must have rules complying with the requirements of Part VII, which require close-out netting procedures against defaulters.\textsuperscript{182}

“Market contracts” include: (1) contracts connected with an RCH\textsuperscript{183} and (2) contracts entered into by the clearing house with a clearing member for the purpose of enabling the rights and liabilities of that member under transactions in investments to be settled.\textsuperscript{184} Although the general law of insolvency has effect in relation to market contracts and action taken under the

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\textsuperscript{177} The Financial Services and Markets, Statutory Instrument 2001 No. (U.K. Treasury), also contains some provisions regarding the operations of CCPs in England.

\textsuperscript{178} c.40, Part VII, ss. 154-207.

\textsuperscript{179} s. 154.

\textsuperscript{180} The FSA is the U.K. regulator of financial market CCPs. See s. 47, Markets in Financial Instruments Directive 2004/39/EC (MIFID).

\textsuperscript{181} See WOOD, supra note 11, at para. 7-026.

\textsuperscript{182} *Id.* at para. 7-027.

\textsuperscript{183} Section 155(1).

rules of an RCH.\textsuperscript{185} this is only the residual rule. The Act expressly provides in section 159 that the proceedings of an exchange or clearing house take \textit{precedence} over insolvency procedures; as such, insolvency rules have been modified. It expressly provides that a “market contract”, the “default rules”, or the “settlement rules” of a clearing house “shall not be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of the assets of a person on bankruptcy, winding up... or in the administration of an insolvent estate”.\textsuperscript{186}

The powers of the relevant office-holder in his capacity as such,\textsuperscript{187} and the powers of the court under the Insolvency Act 1986 shall not be exercised in such a way as to prevent or interfere with (1) the settlement in accordance with the rules of an RCH of a market contract not dealt with under its default rules, or (2) any action taken under the default rules of such a clearing house.\textsuperscript{188}

A debt or other liability arising out of a market contract which is the subject of default proceedings may not be proved in a winding-up or bankruptcy and shall not be taken into account for the purposes of any set-off until the completion of the default proceedings.\textsuperscript{189} Although the Act does not specifically protect multilateral netting arrangements, Professor P.R. Wood suggests that the Act “\textit{probably} validates multilateral netting if permitted under the approved default rules”\textsuperscript{190} of the clearing system, even after the commencement of insolvency proceedings.

\textsuperscript{185} s. 158.
\textsuperscript{186} s. 159(1).
\textsuperscript{187} I.e. an administrator or liquidator.
\textsuperscript{188} s. 159(2).
\textsuperscript{189} s. 159(4).
\textsuperscript{190} WOOD, \textit{supra} note 11, at para. 7-028. Emphasis added.
Therefore, clearing arrangements are in effect exempt from corporate insolvency laws, even though the term “exemption” is not included. It would be more accurate to argue that they do not fall within the scope of corporate insolvency laws, since CCPs are sui generis financial institutions, and not ‘corporations’ in the traditional sense of the word.

(A) Restrictions on Corporate Insolvency Laws

The application of the Insolvency Act 1986 to CCP arrangements has been restricted in several ways. Section 161 (4) gives precedence to the default procedures of a clearing system over insolvency laws and prohibits a statutory freeze or stay on proceedings after an insolvency. This allows the CCP to multilaterally close-out exposures immediately upon the occurrence of an insolvency event and to avoid problems associated with counterparty, liquidity and systemic risk.

Section 163 (5) protects the netting of claims under the default rules, even where a counterparty creditor was put on “notice”\(^ {191}\) that a debtor counterparty was holding a meeting of creditors and that a winding-up petition was pending. Section 164 (1) protects the clearing arrangement and margin schemes from liquidators and the courts. It specifically prohibits a liquidator from disclaiming onerous market contracts and property, i.e. from ‘cherry-picking’, and prohibits the courts from rescinding contracts.

Section 164 (3) avoids the insolvency rules which prohibit post-petition disposals of property after the commencement of winding-up or presentation of a bankruptcy petition with regard to any market contracts or margin schemes, except for where a creditor that has accepted margin from a counterparty has “notice” that the margin provider has presented such a

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\(^{191}\) s. 163(4).
petition. Furthermore, section 165 prohibits the application of insolvency rules governing transactions at an under-value, preferences, and transactions defrauding creditors.

(ii) **Financial Services and Markets Act (FSMA) 2000**

The FSMA outlines the authorization requirements to become a CCP system. This Act suggests that CCP arrangements are self-regulatory organizations which are free to develop their own customs and practices and that will be held accountable according to such practices. Nevertheless, the Secretary of State and the Treasury still have the power to make regulations which govern contracts dealing with “settlement arrangements”.

(A) **Rules and Practices**

The “practices” of RCHs include the “practices of the clearing house in respect of its clearing arrangements”. The “regulatory provisions” include the “rules” or any “guidance” issued by the clearing house, and the particular “arrangements” and “criteria” of the clearing house.

The rules of a clearing house are the rules made, or conditions imposed, by the clearing house with respect to (a) recognition requirements; (b) admission of persons to, or their

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192 Sections 164 (3), (4) and (5).
193 c.8, Part XVIII, ss.285-324. The FSMA and Recognition Requirements Regulations (RRR) build on the Companies Act 1989 rather than repeal it. FSMA Part XXIV gives the FSA various new powers in relation to the insolvency of authorized firms, some of which may overlap with certain RCH powers under C.A.1989 in relation to insolvency clearing members. See RICHARD HEFFNER, THE REGULATION OF MULTILATERAL CLEARING IN THE UNITED KINGDOM AND UNITED STATES, Chapter 5 in DICK FRASE & HELEN PARRY, SPECIAL REPORT: EXCHANGES AND ALTERNATIVE TRADING SYSTEMS (Sweet & Maxwell, 2002), at para. 5.79.
194 s. 301 (1), (2).
195 s. 302.
196 s. 302 (a).
197 s. 302 (b).
198 s. 302 (d). The Director General of Fair Trading must keep under review the regulatory provisions and practices of the relevant system for competition law purposes. s. 303.
exclusion from the use of, its facilities; or (c) matters relating to its constitution.\textsuperscript{199} The guidance issued by a clearing house includes any recommendation made, in writing or other legible form and intended to have continuing effect, by the clearing house to (a) all or any class of its members, or (b) persons using or seeking to use its services, with respect to the provision by it or its members of clearing services.\textsuperscript{200}

The rules of a CCP are well protected under the FSMA. This is evidenced by the fact that although the FSA Handbook\textsuperscript{201} requires the RCH to consult its participants of any rule changes “in appropriate cases”, this is not required for “minor changes to any rules of an administrative or commercial character”\textsuperscript{202} or in cases of emergency. Furthermore, the content of the system rules are protected from complaints by the participants.\textsuperscript{203}

Therefore, the FSMA is compatible with the E.C. Regulation on CCPs 2010, which suggests that CCPs still retain the power to make their own clearing rules, subject to a few minimum regulatory requirements.

\textbf{(B) Potential for Legal Uncertainty}

Although “clearing” and “settlement” are not specifically defined as regulated activities under FSMA, Richard Heffner argues\textsuperscript{204} that the clearing services which a CCP provides may fall within FSMA’s definition of “dealing in investments as principal”,\textsuperscript{205} unless there is a

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\textsuperscript{199} s. 313 (2) – Interpretation of Part XVIII.  
\textsuperscript{200} s. 313 (4).  
\textsuperscript{201} REC 2.14.  
\textsuperscript{202} REC 2.14.4G.  
\textsuperscript{203} RRR para. 23; REC 2.16.1.  
\textsuperscript{204} Supra note 193, at paras. 5.17, and 5.20-5.23.  
\textsuperscript{205} Schedule 1, at para. 2(1), and FSMA Regulated Activities Order (S.I. 2001 No. 544), art. 14.
specify exclusion. Furthermore, the safeguarding and administration of margin collateral may constitute a regulated activity where the collateral consists of investments. However, this uncertainty has been clarified by the E.C. Regulation on CCPs 2010, which expressly states in Article 12 (3) that the European Commission has the power to adopt regulatory technical standards specifying capital requirements.

(C) Role of FSA

An RCH must notify the FSA of any changes in its rules, guidance or operational matters. Further, the FSA can request information from an RCH and it can launch a special investigation into an RCH’s affairs if it suspects that the RCH has breached a specific provision under sections 168 (1), (2) and (4). The FSA’s enforcement powers include the power to direct an RCH to comply with a certain obligation, and the power to revoke the recognition of an RCH that does not satisfy the relevant recognition requirements. The FSA must follow the procedures in FSMA in exercising its powers, i.e., notifying the RCH of the direction or revocation order. Furthermore, the FSA may permit an RCH to investigate any market misconduct committed by its members. This is consistent with a CCPs role as an SRO.

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206 Which he suggest that RAO arts. 15 (securities) and 16 (derivatives) may provide.
207 ROA, art. 40 at para. 5.23.
208 s. 293, FSMA.
209 s. 165, FSMA.
210 s. 168, FSMA.
211 s. 296, FSMA; REC 4.6.
212 s. 297 (2), FSMA; REC 4.7.
213 s. 298.
214 s. 128(1), FSMA.
Richard Heffner argues that it is doubtful that the FSA’s general injunction\(^{215}\) and restitution\(^{216}\) powers can apply to breaches of RCH rules. Although the FSA does not have the power to enforce any breaches of the RCH rules by clearing members,\(^{217}\) the common law fills in the gaps in this area by making the CCP rules binding on its members. The new transnational lex mercatoria recognizes that the clearing rules are binding on the clearing members. Nevertheless, the FSA may soon receive new powers under Article 9 (1) of the E.C. Regulation on CCPs, which requires the regulatory authorities of each Member State to impose and enforce penalties against CCPs that breach any of the rules in the Regulation.\(^{218}\)

(c) **United States**

(i) **Dodd–Frank Wall Street Reform and Consumer Protection Act 2010**\(^{219}\)

CCPs operating in the derivatives markets are classified as Derivatives Clearing Organizations (DCO).\(^{220}\) Section 725 (c) amends section 5b (c) of the *Commodity Exchange Act*\(^{221}\) to provide DCOs with discretion to determine certain aspects of their business. It states that:

> “Subject to any rule of regulation prescribed by the [CFTC], a derivatives clearing organization shall have *reasonable discretion* in establishing the manner by which the derivatives clearing organization complies with each core principle...”\(^{222}\)

\(^{215}\) s. 380, FSMA, court injunction.

\(^{216}\) s. 382, FSMA, court order for restitution.

\(^{217}\) See HEFFNER, *supra* note 193, at para. 5.56.

\(^{218}\) It should be noted that under the E.C. Regulation on CCPs 2010, the European Commission and the ESMA will begin to supervise and oversee the actions of the domestic Member State regulators. This may curtail some of the FSA’s powers. See Regulation on CCPs 2010, *supra* note 2, at art. 18.

\(^{219}\) H.R. 4173.

\(^{220}\) s. 725.

\(^{221}\) 7 U.S.C. 7a-1(c).

\(^{222}\) Emphasis added.
Therefore, CCPs maintain a discretion in determining how they perform their operations with regard to financial resources, participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, rule enforcement, system safeguards, reporting, recordkeeping, public information, information sharing, anti-trust considerations, governance fitness standards, conflicts of interest, and legal risk.

Although the Act has restricted the ability of CCPs to choose what financial products they clear with the mandatory clearing of standardized OTC contracts, it appears that CCPs still have a wide discretion to innovate and create new clearing, settlement and risk management procedures. This discretion is merely subject to stricter regulatory oversight than it previously was.

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223 Minimum amount of financial resources. S.725 (c)(B)(ii).
224 “Each derivatives clearing organization shall ensure that the derivatives clearing organization possesses the ability to manage the risks associated with discharging the responsibilities of the derivatives clearing organization through the use of appropriate tools and procedures”. S.725 (c)(D)(i). Therefore, a CCP has a discretion to develop the appropriate risk management tools and procedures necessary, including measurement of credit exposures, limitation of exposures to potential losses from default, and margin requirements.
225 Settlement finality, netting and set-off. S.725 (c)(E).
226 Safety of member and participant funds, holding of funds and assets, permissible investments. S.725 (c)(F).
227 Each DCO shall have rules and procedures designed to allow for the efficient, fair and safe management of events during which members or participants become insolvent or default on their obligations. Default procedures – each DCO shall clearly state defaults procedures and make publicly available the default rules of the DCO. S.725 (c)(G)(i).
228 Monitoring and enforcement of compliance with the DCO rules. S.725 (c)(H).
229 Periodically conduct tests to verify that the backup resources of the DCO are sufficient to ensure daily processing, clearing and settlement. S.725 (c)(I).
230 Each DCO shall have a well-founded, transparent, and enforceable legal framework for each aspect of the activities of the DCO. S.725 (c)(R).
231 Section 723 (‘Clearing’), Title VII: Wall Street Transparency and Accountability, Dodd-Frank Act 2010, H.R. 4173-300.
(ii)  **The Bankruptcy Code 1978**

Title 11 provides a contractual right to liquidate, terminate, or accelerate a securities contract, a commodities contract or forward contract, a repurchase agreement, a swap agreement, and offset under a master netting agreement and across contracts.

“The term “contractual right” includes a right set forth in a rule or bylaw of a derivatives clearing organization, a multilateral clearing organization, a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the *Commodity Exchange Act*, a derivatives transaction execution facility registered under the *Commodity Exchange Act*, or a board of trade or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under *law merchant* or by reason of *normal business practice*.

These exemptions from bankruptcy laws mean that set-off is not the subject to the automatic stay or the “mutuality” requirement in §553. There is also an express recognition of the lex mercatoria and the practices of CCP systems. Therefore, the new transnational lex mercatoria is compatible with this legislation.

(d) **Canada**

The patchwork of legislation is more noticeable in Canada than in any other common law jurisdiction. CCPs are governed by both federal and provincial legislation. The federal legislation

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233 Id. §555.
234 Id. §556.
235 Id. §559.
236 Id. §560.
237 Proceedings under chapter 15, §561.
238 It has been stated that a “Contractual right” is broadly defined to include a right, whether or not evidenced in writing, arising under common law, under *law merchant* or by reason of *normal business practice*, suggesting that even dealings in the ordinary course of the derivatives business gives rise to contractual rights. Therefore, it appears the plain language of the safe harbor provisions bars the limitation of setoffs of debts whether mutual or not, if effective under state law”. Martin J. Bienenstock, Chris DiAngelo, Eileen Bannon, & Lee J. Cassey, *Are Triangular Set-off Agreements Enforceable in Bankruptcy?*, 83 AM. BANK. L.J. 325, 339 (2009).
239 As defined in the *Commodity Exchange Act* 1936, 7 U.S.C. 1.
241 As defined in the *Commodity Exchange Act, supra* note 231.
242 Emphasis added.
includes the Bankruptcy and Insolvency Act (BIA),\textsuperscript{243} which was amended\textsuperscript{244} in 1992 to protect ‘Eligible Financial Contracts’ (EFCs) from various stays imposed by the statute.\textsuperscript{245} The Budget Implementation Act 2007\textsuperscript{246} amended the Winding-up and Restructuring Act (WURA)\textsuperscript{247} by introducing a broader definition for EFCs. It recognized insolvency set-off and the ability of parties to EFCs to realize collateral securing their net positions upon the insolvency of their counterparty.

The Montreal Exchange (MX)\textsuperscript{248} is Canada’s financial derivatives exchange, and it is regulated by the Autorité des Marchés Financiers.\textsuperscript{249} All trades executed on MX are cleared and settled by the Canadian Derivatives Clearing Corporation (CDCC) CCP.\textsuperscript{250} The CDCC receives federal statutory protection from the Payment Clearing and Settlement Act (PCSA)\textsuperscript{251} in the event of insolvency proceedings.\textsuperscript{252} Furthermore, the CDS Clearing and Depository Services Inc. is Canada’s national securities depository and CCP for securities.\textsuperscript{253} It is regulated by the

\begin{itemize}
\item \textsuperscript{243} R.S.C. 1985, c. B-3.
\item \textsuperscript{244} S.C. 1992, c.27.
\item \textsuperscript{245} S. 65.1 was amended to allow the termination and netting of obligations owing pursuant to these agreements upon one party becoming insolvent.
\item \textsuperscript{246} S.C. 2007, c. 29.
\item \textsuperscript{247} R.S.C. 1985, c. W-11.
\item \textsuperscript{248} The MX is a subsidiary of TMX Group.
\item \textsuperscript{249} The Autorité des Marchés Financiers Act, R.S.Q., c. A-33.2. This is an independently-governed self-regulatory organization.
\item \textsuperscript{250} The Quebec Derivatives Act, R.S.Q. 2008, c. 1-14.01 2008, c. 24, a provincial act, defines a “clearing house” as a person who maintains a system for netting derivatives trades on a multilateral basis and who acts as central counterparty to that end. §2.46 states that “derivatives clearing” includes all arrangements through which a clearing house, in accordance with its rules, matches positions between market participants or parties to derivatives; receives margin deposits or margins, and mutualizes or transfers the credit risk arising from a derivative among its members or clearing agents; substitutes the credit of the clearing house for that of the parties to a derivative; and nets those transactions on a multilateral basis, and settles them or, failing settlement, liquidates or cancels the relevant positions.
\item \textsuperscript{251} S.C. 1996, c. 6, Sched.
\item \textsuperscript{252} The Budget Implementation Act, 2007 updated the CPSA the same way as the WURA. The PCSA gives the Bank of Canada responsibility and oversight of clearing and settlement systems in Canada to control systemic risk. The PCSA reinforces the legal enforceability of netting in designated systems when it is combined with federal insolvency legislation. See PCSA Preamble, supra note 251.
\item \textsuperscript{253} “CDS, the owner and operator of Canada’s [Securities Settlement System] (called CDSX), is both the [Central Securities Depository] and a CCP. CDS becomes the CCP for the funds leg of all securities transactions settled in
\end{itemize}
Ontario\textsuperscript{254} and Quebec securities commissions, and it is subject to the Companies’ Creditors Arrangement Act,\textsuperscript{255} the Canada Deposit Insurance Corporation Act,\textsuperscript{256} the PCSA, the BIA, and the WURA.\textsuperscript{257}

\section*{9. FUTURE DEVELOPMENTS FOR FINANCIAL MARKET CCPs}

Financial market CCPs have had contractual freedom as SROs to govern their operations to suit their business needs. The new transnational lex mercatoria has recognized these customs and practices when legislation has not. Although the legal regimes governing CCPs have recently been modified in the E.U. and the U.S., it is evident that the new legislative reforms are fully compatible with the new transnational lex mercatoria.

\textbf{(a) The Impact of the Legislative Reforms}

The 2007-2010 global financial crisis gave rise to a consensus among the policy-makers of the major financial markets, notably the U.S., E.U., England and the other G-20 governments, to shift ‘standardized’ OTC contracts onto CCPs for mandatory clearing. The legislative reforms aim to neutralize counterparty risk and increase transparency in order to protect the financial markets from the threat of systemic risk. Since there have never been any major CCP failures, concentrating more risk into CCP systems is considered the best approach.

\textsuperscript{254} The Ontario Commodity Futures Act, R.S.O. 1990, c. C.20, is a provincial act that defines the roles of a “clearing house”, a “self-regulatory organization” and the “Ontario Securities Commission”.
\textsuperscript{255} R.S., 1985, c. C-36.
\textsuperscript{256} R.S., 1985, c. C-3.
\textsuperscript{257} See CDS Rules version 3.11, s. 1.3.13.
Nevertheless, there is some resistance for the reforms from some academics and market participants. Firstly, Ruben Lee\textsuperscript{258} has argued that the regulatory requirement to clear OTC contracts will likely be a costly failure. It is being done for the wrong reasons, which consist of a convergence of linked political, regulatory and commercial incentives. CCPs will lose some freedom to choose which contacts they desire to clear. This may affect a CCPs’ ability to properly perform its risk management operations, since some derivatives contracts are too customized to be cleared.\textsuperscript{259} Lee has argued that “it is optimal for a CCP to choose what contracts to clear, precisely because it has a strong incentive to ensure that such contracts are eligible to be cleared. If they are not, the CCP and its membership will likely face significant costs in the event of a member bankruptcy”\textsuperscript{260}

Standardized OTC contracts may not always be very liquid,\textsuperscript{261} which creates problems when assessing default scenarios. In support of this critical view, the U.K. House of Lords has voiced some concern over the financial reforms proposed by the European Commission in its Communication on \textit{Ensuring Efficient, Safe and Sound Derivatives Markets}.\textsuperscript{262} Although the House of Lords has shown general support for the reform proposals, they stated that:

\begin{quote}
“the Commission suggestion that central clearing for all standardized products should be mandatory did raise some issues. This proposal if adopted could increase risk by forcing clearing
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\textsuperscript{259} “If a regulator is given the power to decide what contracts should be cleared via a CCP, however, it may well require some contracts to be centrally cleared that are not eligible for clearing. This is because the regulator will not directly bear the costs of any problems at the CCP arising as a result of such contract ineligibility. This will lead to problems and, at the extreme, failures at CCPs”. \textit{Id.} Lee.
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Furthermore, the U.K. FSA and Treasury have stated that: “We do not support proposals to mandate CCP [central counterparty] clearing for all standardized derivatives. Mandating the clearing of all standardized derivatives could lead to a situation where a [clearing house] is required to clear a product that it is not able to risk manage adequately, with the potential for serious difficulties in the event of a default”. The director of markets at the FSA, Alexander Justham, has stated that “the concern is that if you force things to go through CCPs that can’t be risk managed, you create a new risk point”; Jeremy Grant, \textit{UK Rejects Plans for OTC Standardisation}, The FT, Dec.16 2009.
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\textsuperscript{260} \textit{Id.} Lee.
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\textsuperscript{261} This means that the assets are difficult to sell and cannot be easily exchanged for cash.
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houses to clear products for which they cannot manage the associated risk effectively. Moreover, not all derivatives contracts are suitable for standardization.”

This suggests that CCPs should not be forced to clear products that they do not have the intention or capability of clearing. This could be counterproductive to their current business model.

Secondly, increased regulatory intervention may affect certain practices of CCP systems, such as those involved in collateral management. The relevant regulatory authority may be given the power to dictate which types of assets can be accepted by the CCP as collateral for a clearing member’s financial exposures.

Thirdly, a mandatory requirement for the clearing of OTC contracts may introduce the problem of moral hazard into CCP systems. It is likely that there will be an implicit guarantee from the local government or the central bank where the CCP is located to financially support or bail it out in times of crisis. This is especially true if the CCP is interconnected with other financial institutions and is deemed “too big to fail”.

Therefore, moral hazard means that the CCP may become less concerned with its risk management practices, and may focus its attention on increasing profits.

The critics tend to agree that the method used for shifting OTC contracts onto CCPs, i.e. a mandatory shift originating from legislation, is the wrong approach. It restricts the ability of CCP systems to manage their operations as SROs to suit their current business needs, and it could force them to radically alter their customs and practices as a result of changing

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264 The director of general payments and market infrastructure at the European Central Bank, Daniela Russo, has stated that “if the CCP knows it will be supported by [a] central bank, this will be a very dangerous incentive not to manage risk”; Grant, supra note 1.
265 In support of this view, Ruben Lee argues that “the search for crisis-mitigating policies is necessary. The objective of reducing systemic risk by requiring centralized clearing for OTC derivatives is desirable. Unfortunately, however, the policy will not be effective”. Supra note 258.
incentives. Ultimately, this could undermine the legal force of the new transnational lex mercatoria and its applicability to financial market CCPs.

It is arguably preferable for CCPs to take the initiative and alter their customs and practices from within. Some CCP systems chose to provide clearing services for certain OTC contracts before the financial crisis began. Policy-makers and regulators should consider carefully how much becomes mandatory under the legislative reforms and how these changes will affect the operations of CCP systems in the long term. It may be counterproductive to restrict the ability of CCPs to manage their own business. There has never been a major CCP failure and these systems have governed their own operations successfully for decades. CCPs have not been adversely affected by the financial crisis, and they have demonstrated to know their business better than the politicians, legislature and judges.

The new transnational lex mercatoria has provided a legal platform for CCP systems to successfully carry out their operations without much external influence, and it should be allowed to continue to be the legal regime which governs the operations of these systems. Nevertheless, it is observed that the new financial reforms and the new transnational lex mercatoria are compatible, provided that the relevant regulators do not overly restrict the ability of CCPs to innovate and govern their own operations. Otherwise the potential arises for undesired and unpredictable risks to be introduced into CCP operations.

266 Jeremy Grant has observed that “clearers are jostling for as much of the available business as they can get, prompting concern that some clearers may be tempted to loosen their financial standards to attract business. Roger Liddell, chief executive of LCH.Clearnet, the London-based clearer, claims certain unnamed clearers are already “competing on margin”, referring to the funds market participants must post upfront to cover possible losses”; Grant, supra note 1.

267 Furthermore, Anthony Belchambers, head of the Futures and Options Association, has argued that “this kind of regulatory pressure will distort free-market competition and restrict product diversity”. Gillian Tett & Aline Van Duyn, Let Battle Commence, The FT, May 19 2009.
Although the executives at some of the major CCP systems\textsuperscript{268} had initially expressed their concerns over the legislative reforms, there has not been great resistance due to the increasing amounts of business and the potential source of profits that the clearing of standardized OTC contracts may bring to existing CCP operators.\textsuperscript{269} This demonstrates that the incentives of some CCP operators may already have changed, even before the legislative reforms have been implemented.\textsuperscript{270}

(b) Potential Pitfalls of the New Transnational Lex Mercatoria

The new transnational lex mercatoria should not be a separate legal regime which operates unhindered and unsupervised. Even though CCP systems have emerged from the rubble unscathed, the financial crisis has demonstrated that the global banking community was able to abuse the freedom which the lex mercatoria provided them with. Many financial institutions altered their customs and practices to create innovative, yet inherently risky, financial products.\textsuperscript{271} This problem can be avoided in the future by creating regulatory authorities that will provide sufficient oversight and monitor the operations of systemically important financial institutions by imposing minimum safeguards and standards on them.\textsuperscript{272}

\textsuperscript{268}“Clearing houses themselves have fought to retain control of which products can be cleared”; The Lex Team at the Financial Times, \textit{Clearing Houses}, Dec.16 2009.

\textsuperscript{269}Jeremy Grant has noted that “clearing houses were never really supposed to behave as profit-seeking businesses, with all that implies in terms of aggressive price cutting and out-manoeuvring your rivals … Some would suggest clearing houses were supposed to remain quasi-utilities …Yet as regulators push for more clearing of OTC derivatives, it has become clear that clearing will compete with each other for business – and already are … The nightmare scenario is of course that in its zeal to attract customers – some all too happy to accept lower margin requirements – a clearer might take on too much risk and itself defualt, sparking a fresh financial crisis”; Jeremy Grant, \textit{Quick View: LCH.Clearnet versus IDCG}, The FT, April 16 2010.

\textsuperscript{270}The deadline for implementing changes to the law is 2012 according to the G20 Pittsburgh Summit (September 2009).

\textsuperscript{271}The products include, \textit{inter alia}, a list of securitized assets (such as Collateralized Debt Obligations) and credit derivatives (such as Credit Default Swaps).

\textsuperscript{272}E.g., the ESMA is a new regulator in the European Union. It safeguards the stability of financial markets, develops legally binding regulatory technical standards and has a central role in the authorization and monitoring of
of policy-makers and regulators to find the right balance between the public and private regulation of CCPs.

Regulators should consider that CCP systems do not have the incentive to become involved in risky business like other financial institutions did. Firstly, CCPs have traditionally been risk neutral financial institutions. Their function is to concentrate risk within the system in order to neutralize counterparty risk with their risk management procedures. Secondly, CCPs were traditionally user-owned and did not have a profit-making incentive. 273

Therefore, CCPs require a minimum amount of regulation and oversight, and regulators should consider whether the new financial reforms will change the CCP business model. CCPs may compromise on their risk management operations if their incentives are geared towards increasing profits from the resulting increase in business that will arrive with the mandatory shift of OTC contracts onto CCPs for clearing.

10. CONCLUDING REMARKS

This article demonstrates that the new transnational lex mercatoria has been recognized by the common law courts in various common law countries as the appropriate source of law governing the operations of CCP systems, whether these are financial market or non-financial market CCPs. In the future, regulators need to find a proper balance between the binding force of regulation and the force of CCP customs and practices, and resolve how these two issues

273 However, now CCPs are increasingly becoming demutualised for-profit institutions, which means their incentives may be changing. This view is not supported by a recent BIS-CPSS report, which concludes that “there appears to be no clear relationship between ownership and systemic risk: there is no evidence to conclude that either a user-owned or a for-profit ownership model would be more (or less) likely to undermine CCP risk management”. See CPSS, Market Structure Developments in the Clearing Industry: Implications for Financial Stability, Report of the Working Group on Post-Trade Services, September 2010, at 3.
interrelate. The SEC and the CFTC in the U.S., and the ESMA in the E.U., should implement the legislative reforms in a way that does not hinder the binding force of CCP customs and practices. This could have a negative impact on innovation and efficiency that CCPs provide.

Since financial regulators in the U.S. and the E.U. are encouraging a shift of standardized OTC contracts onto regulated exchanges with CCPs, it is necessary for regulators to develop a system which is an efficient and cost effective alternative to private bilateral OTC dealings. As a matter of commercial policy, regulators and the courts should continue to give CCPs flexibility to develop their own market customs and practices under the new transnational lex mercatoria.

CCPs have traditionally been user-owned institutions and their operations have been developed by the owner institutions in order to realize their commercial and economic interests. It is justified to give CCP systems the flexibility to self-regulate as SROs and the freedom to innovate through contract. CCP systems have rarely failed in the past and have proven through their arrangements and market practices to be the most resilient financial institutions during the 2007-2010 global financial crisis.

As a general rule, a CCP should only be allowed to supersede domestic laws which would disrupt the operations of a CCP system or would enhance systemic risk. For example, this would allow non-financial market CCPs, which are not (yet) governed by any particular legislation in most common law jurisdictions, to supersede burdensome domestic insolvency laws. This is justified, since corporate insolvency laws apply specifically to ‘corporations’, and not to CCP systems, which through their customs and practices have evolved into *sui generis* financial institutions.

This should not allow financial market CCPs to supersede legislative or regulatory protections. These minimum controls and standards are in place to protect the financial system
from systemic risk. A financial market CCP would not have to supersede these laws in practice, since there would not usually be a conflict between the customs, practices and the statutes governing their operations. These laws will usually have been drafted to accommodate CCP practices.

Notwithstanding the new legislative reforms in the U.S. and E.U., the new transnational lex mercatoria remains the proper legal regime governing CCP systems. It is the only legal regime governing the operation of non-financial market CCPs, since these do not receive statutory protections. The legislative reforms suggest that it remains the fall-back legal regime for financial market CCPs when carve-out statutes do not resolve a particular legal issue. Therefore, the courts in common law jurisdictions can continue to look at the customs and practices of CCP systems as a valid source of law to resolve legal issues regarding CCP arrangements.
11. BIBLIOGRAPHY


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