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Introduction

This article will revisit issues involved in transferring trading positions. We will begin with a refresh on the legal differences between assignment and novation. We will then consider how different categories of trading positions (or 'asset classes') can be transferred. Finally, we will examine some issues to watch out for when reviewing transfer provisions in trading agreements.

Counterparties will frequently wish to transfer positions for a host of reasons, including acquisitions and restructurings, ceasing to provide a particular service, and tax and regulatory issues. Recently, in the context of Brexit, counterparties may have been novating contracts from a United Kingdom (UK) entity to a European Union affiliate.

From a legal perspective, the transfer of positions can cover a wide spectrum of 'difficulty', ranging from vanilla operational procedures to extremely complex legal projects.

The meaning of "transfer"

"Transfer" is a generic term used to describe the process by which a party's rights and/or obligations move to another party. "Assignment" and "novation" are specific terms denoting techniques under English law used to 'transfer' rights and/or obligations to a third party.

Assignment and novation: how do they differ?

An assignment passes only rights (i.e., benefits) under a contract to a third party, whereas a novation passes both rights and obligations (i.e., benefits and liabilities) under a contract to a third party.

Assignment

An assignment under English law involves a transfer of a party's rights, but not its obligations, under a contract to a third party. The parties to the contract do not change. Assignments can be broadly split into two categories, 'legal' and 'equitable'.

A legal assignment must comply with certain statutory formalities, including the giving of notice of the assignment to the contract counterparty. A legal assignment results in contractual relations between the contract counterparty and the legal assignee, meaning that the legal assignee can usually bring an action directly against the contract counterparty.

An equitable assignment takes effect if the requirements of a legal assignment are not met, including where notice of the assignment is not given to the contract counterparty. This results in no direct contractual relations between the contract counterparty and the equitable assignee, with the result that the equitable assignor continues to be treated by the contract counterparty as its counterparty for all purposes, and any action which the equitable assignee wishes to bring against the contract counterparty will need to be brought through, or jointly with, the assignor.

Prohibitions on assignment under contracts

If a contract expressly prohibits assignments of specific rights – or all rights – under the contract, an equitable assignment may still be valid, the consequence being that the equitable assignee would be able to bring an action against the equitable assignor, but not the contract counterparty.

Different interpretation of 'assignment' in overseas jurisdictions

In certain overseas jurisdictions, the term 'assignment' is frequently used to generically describe a transfer of obligations as well as rights – for example, under New York law, the concepts of assigning rights and delegating obligations may be merged into the use of the term 'assignment' to describe both.

Novation

A novation under English law involves a 'transfer' of both a party's rights and its obligations under a contract to a third party, meaning that the parties to the contract change. One of the parties 'remains', whilst the other party (the transferor) is replaced with a new party (the transferee).

This is achieved by extinguishing the original contract and replacing it with a new contract between the new parties under which the rights and obligations of the transferor are assumed by the transferee, with the transferor at the same time being released from those same rights and obligations. The remaining party is left in the same position as before the novation takes place, it just faces a different counterparty.

The consent of all parties (transferor, transferee and remaining party) is required.

Prohibitions on novation under contracts

Even if a contract expressly prohibits 'transfers', the subsequent written agreement of all parties to the contract to allow a novation to take place will supersede any such prohibition.

Novating derivatives

In the over-the-counter (OTC) derivatives world, novation is a frequently-used process, typically involving template documentation developed by the International Swaps and Derivatives Association, Inc. (ISDA).

ISDA Novation Agreement

The 2002 ISDA Novation Agreement is widely used to transfer by novation rights and obligations under OTC derivatives transactions to a new counterparty. It is structured to effect the transfer of one or more individual transactions, or groups of transactions, from the ISDA Master Agreement between the original contract parties to the ISDA Master Agreement between the new contract parties. In that way, and in keeping with ISDA architecture, the trades themselves move between two different governing agreements. It is also possible, by some redrafting of the ISDA Novation Agreement, to novate the ISDA Master Agreement as well as underlying transactions.

ISDA Novation Confirmation

Alternatively, under ISDA documentation architecture, parties may effect a novation by executing a Novation Confirmation, whereby the novated transactions are subject to the 2004 ISDA Novation Definitions. These Definitions provide the framework governing the novation process and include a template Novation Confirmation, which incorporates by reference the terms of a standard ISDA Novation Agreement. This less popular process adopts similar novation mechanics under the guise of different documentation.

ISDA Novation Protocol

Finally, ISDA has created 'protocols' providing legally-binding mechanisms for parties to consent to a novation. Under the ISDA Novation Protocol, the transferor and transferee agree the terms of the novation of credit derivative and interest rate derivative transactions, subject to the consent of the remaining party. If the remaining party's consent is received by the specified deadline, the novation goes ahead.

If the remaining party's consent is not received by the specified deadline, the novation does not go ahead but instead a new transaction arises between the transferor and transferee on the agreed terms, effectively acting as a hedge for the transferor. The ISDA Novation Protocol was originally created to reduce confirmation backlogs and provide a more efficacious process for novation.

A tailored version, the ISDA Master FX Novation and Cancellation Protocol, was created for the foreign exchange (FX) market.

Novating prime brokerage business

All prime brokers use their own 'house' proprietary prime brokerage agreements reflecting their own internal policy positions, operational imperatives and chosen style of legal drafting.

Pursuant to a fund restructure (for example, a "single fund" to "master-feeder" structural reorganisation), novation can be used to transfer entire books of prime brokerage business from one fund to another, subject to the rights and obligations being suitable for novation. Such operations may typically involve a combination of novation and redesignation of beneficial ownership (for example, redesignation of 'cash' securities positions).

The transferee fund will contract on the same terms as the transferor fund, subject to the prime broker receiving assurances that appropriate consideration at market value has passed between the funds.

However, pursuant to an acquisition, merger or restructuring involving the prime broker, novation can prove trickier. The principle of novating rights and obligations (alongside redesignation of beneficial ownership) can still work, the problem being that the recipient prime broker will wish to take on the transferred business under its own proprietary prime brokerage terms. Whilst theoretically possible, this may become too complicated for practical purposes, the documentation challenge being too timeconsuming and resulting in unclear contractual terms.

Novating other trading agreements

The core principles of novation can be applied, in theory, to any contract. However, the practicalities frequently raise complications. It is generally possible to apply novation to nonderivatives asset classes, whilst remembering that novation deals with contractual rights and obligations and will not take care of (for example) transfers of securities and collateral. Novation procedures are also frequently limited by operational imperatives.

In which case, transfers may be undertaken by way of a combination of novation and closing and re-opening of positions.

Transfer provisions: be sure to know your counterparty

Contracts frequently contain transfer provisions allowing a party to transfer some or all of its rights and obligations, either with or without notice, to its affiliate or other third party.

Imagine that, having completed an onboarding process with your counterparty, GoldPlated UK Bank PLC, you one day discover that GoldPlated UK Bank PLC has transferred some or all of your counterparty relationship to an unknown entity established in an unfamiliar jurisdiction.

Provisions purporting to allow such transfers are reasonably common in ISDA Master Agreements, prime brokerage agreements and other relevant trading agreements.

A sell side argument for their inclusion may be focused on an imperative for the swap dealer or prime broker to move positions (whether for one client or all clients) to an affiliate for tax or regulatory reasons. A swap dealer may, in addition, wish to have a free hand to transfer to a non-affiliated party, including to sell/exit positions.

Whilst a perfectly reasonable position for the sell side to take, fund managers should be wary of allowing such transfer provisions without minimum conditions, for example relating to credit standing, regulatory environment and advance notice.

The fund manager may require a window of time in advance of any transfer in which to conduct due diligence on the proposed transferee and its jurisdiction (including anti-money laundering/know your client and other on-boarding checks and procedures, including ensuring that close-out netting is enforceable in any new jurisdiction).

There may also be regulatory obligations such as submission of a ‘Material Change Notification’ to the UK Financial Conduct Authority not less than 30 days prior to “the appointment, removal or change of function of depositaries” (which generally includes prime brokers and custodians).

Finally, the fund manager may require a window of time in which to exit positions, should it not wish to face the proposed transferee.