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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 144 – INVESTMENT BANKING INSOLVENCY PANEL PROPOSALS

Response to the December 2009 HM Treasury Consultation Document on establishing effective resolution arrangements for investment banks

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CONTENTS

1.	Introduction and Executive Summary	4
2.	Interaction of HM Treasury's Proposals with the Banking Act Provisions	7
3.	Business Resolution Officers	10
4.	Ring-fencing Business Areas	11
5.	Allocating Shortfalls in Client Omnibus Accounts	12
6.	Custodian's Right of Lien over Client Assets	14
7.	Establishment of a Client Assets Trustee	15
8.	Segregation of Investment Firm and Client Accounts at Clearing	20
9.	Termination of Derivatives Contracts	23

1. Introduction and Executive Summary

A) Introduction

1.1 In May 2009, HM Treasury published a consultation document entitled "Developing effective resolution arrangements for investment banks" (the "First Consultation Document"). This was the first consultation document in a series of three to be published by HM Treasury on establishing an effective resolution regime for failing investment firms. The First Consultation Document discussed certain issues that were highlighted by the collapse of Lehman Brothers International (Europe) Limited ("LBIE"), including the treatment of monies and assets belonging to the bank's clients and the treatment of open or unreconciled over-the-counter trading positions following the bank's collapse. It examined what could be done to make the process of insolvency itself more effective and to limit the damage that could be caused by a failing investment firm, outlining, in each case, the UK Government's (hereafter, the "Government's" or "HM Government's") initial thinking on these matters. The Financial Markets Law Committee (the "FMLC") responded, in July 2009, to the First Consultation Document in its paper, "Issue 144 – Investment Banking Insolvency Panel Proposals: Response to the May 2009 HM Treasury Consultation Document on developing effective resolution arrangements for investment banks" (the "Original 144 Paper").

1.2 HM Treasury published, in December 2009, its second consultation document, "Establishing resolution arrangements for investment banks" (the "Second Consultation Document"). After undertaking an initial consultation with industry experts, the Second Consultation Document sets out in greater detail the Government's thinking on establishing an effective resolution regime for investment firms and contains more than 30 policy initiatives designed to mitigate the impact of a failing investment firm.

1.3 This paper focuses on a number of the proposals raised in the Second Consultation Document including, *inter alia*, those associated with the return of client assets and the termination of derivatives contracts and responds to questions set out in the Second Consultation Document (the "Questions")

which are relevant to the proposals discussed herein (i.e. Questions 8, 16, 21, 35, 46, 55, 73 and 80).

1.4 Client assets, as referred to in this paper, are the financial instruments that belong to the clients of an investment firm and are held on their behalf by the investment firm in the course of its investment business. Similarly, client money is money that an investment firm holds for or on behalf of a client in the course of its investment business.

1.5 The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed. This paper, therefore, does not comment on the many important policy issues raised in the Second Consultation Document which are relevant to the establishment of an effective resolution regime for investment firms other than as necessary to deal with issues of potential uncertainty or misunderstanding.

B) Executive Summary

1.6 This paper does not seek to address all of the questions posed by the Second Consultation Document, nor does it seek to identify exhaustively all potential concerns with respect to those proposals discussed herein. The purpose of this paper is to respond to certain key Questions and, in doing so, to set out the views of the FMLC on some of HM Treasury's core proposals and to make recommendations and propose, where relevant, solutions for consideration.

1.7 Accordingly, the FMLC's principal recommendations are as follows:

(a) Greater consideration needs to be given to the interaction of the investment firm special administration regime (the "SAR") with the special resolution regime (the "SRR") established for deposit-taking institutions under the Banking Act (as defined below), the Bank Insolvency Procedure (the "BIP") and the Bank Administration Procedure (the "BAP").

(b) The role of the business resolution officer (the "BRO") should be clearly delineated and restricted to supervising the preparation of and maintaining, once established, the investment firm's resolution plans.

(c) The proposals for investment resolution actions should be mindful of and consistent with the Tripartite Authorities' objective of maintaining the stable functioning of the payments systems.

(d) Any proposed legislation or regulation aimed at clarifying how shortfalls in client omnibus accounts[1] are allocated should have regard to the relevant provisions of the legal framework for modern intermediated securities holding systems which was established by the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the "Geneva Securities Convention").

(e) Client assets held by an investment firm with a third-party custodian should not be subject to a right of set-off, a lien or other form of security interest in respect of liabilities owed by an investment firm, in its capacity as principal, to the third-party custodian. Contractual comfort should be sought, where possible, to this effect and in circumstances where such comfort cannot be obtained, clients must be made aware that their assets are available to the custodian in respect of the investment firm's indebtedness.

(f) The technical aspects of having a special administration regime with an appointed administrator and an independently appointed client assets trustee (a "CAT") needs further consideration, particularly with regard to, *inter alia*, how conflict will be managed and how the additional costs will be covered.

(g) Any attempt to introduce an explicit requirement for central counterparties ("CCPs") to offer facilities for members to segregate their business should have regard to the Part 7 Provisions (as defined

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[1] For the purposes of this paper, an omnibus account is an account in which all "like" securities held by the investment firm, on behalf of its clients, are pooled.

in paragraph 8 below), amended, where necessary, to bring certainty to the process of transaction allocation and to ensure that a clearing member's insolvency is dealt with in an efficient and orderly manner with minimal risk of challenge.

(h) Certainty as to the eventual timing of (i) the early termination of derivatives contracts and (ii) the realisation of the value of open transactions is essential to the successful and efficient wind-down of an insolvent investment firm and the preferred solution for achieving certainty is a market-led solution which would, in effect, amend the terms of the standardised ISDA Master Agreement.

2. INTERACTION OF HM TREASURY'S PROPOSALS WITH BANKING ACT PROVISIONS

2.1 Overview

2.1.1 The Second Consultation Document briefly considers how the special administration objectives (the "SAOs") interact with the provisions of Part 2 (*Bank Insolvency*) of the Banking Act 2009 (the "Banking Act").[2] It emphasises the need for coordination of the applicable insolvency regimes in circumstances where a bank undertakes investment banking activities whilst also retaining deposit-taking permissions (a "Mixed Bank").

2.2 Question 8: Do you agree with the proposals for the initiation and scope of the special administration regime for investment firms and its interaction with the provisions of Part 2 of the Banking Act 2009, as described in Box 2A?

2.2.1 *Application of the SAR to Mixed Banks*

2.2.1.1 HM Treasury's consideration of Mixed Banks in Box 2A of the Second Consultation Document is limited to the interaction of the BIP as set out in Part 2 of the Banking Act and the SAR. No consideration is given to the interaction of (i) the SRR established for deposit-taking institutions under the Banking Act or (ii) the BAP as set out in Part 3 of the Banking Act with the

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[2] See Box 2.A on page 28 of the Second Consultation Document.

SAR. Moreover, the interaction of the BIP and the SAR is described only at a very high level. Greater detail and draft legislative proposals are needed to comment meaningfully on the legal aspects of the proposals although some high level observations have been made below on the assumption that provisions will be added to the SAR to take on board the SRR and the BAP as well as the BIP.

2.2.1.2 Given the potential for complexity in the interaction of existing insolvency law as it applies to banks (including the two modified insolvency regimes under the Banking Act) and the SAR, the authorities should take steps to ensure that the draft regulations establishing the SAR are clear as to their application and their effect on the rights of stakeholders. This is likely to require a thorough review of the provisions in the Banking Act and also consideration of their inter-relationship with the proposals set out in the Second Consultation Document, including "living wills".

2.2.1.3 In addition, to maintain confidence in the wholesale financial markets, it is important that the SAR, or at the very least, the SAOs clearly define the legal rights of an insolvent investment firm's creditors or clients. It is thought that this would, in the context of the resolution of a Mixed Bank, require certain amendments to be made to the existing guidance provided by the authorities on the application of the SRR.

2.2.2 *Application of the SAR following application of the SRR*

2.2.2.1 It is understood that the SRR will apply to Mixed Banks. Accordingly, the stabilisation powers which include, in particular, the Tripartite Authorities' power to transfer a bank's property (in whole or in part) may be exercised with respect to a Mixed Bank. The property transfer may, pursuant to Section 34(7) (*Effect*) of the Banking Act, include a transfer of client assets and client money; similarly, a property transfer under Section 33(2) (*Property transfer instrument*) may include deposits.

2.2.2.2 The need for such stabilisation powers in the SAR and the objectives of the SAR could differ from those of the insolvency regimes under the Banking Act and consideration needs to be given to the interaction of the SRR and SAR in

this respect. For example, following the use of the SRR in relation to a failing bank, the BAP is typically used to deal with the residual company following the transfer. Where a failing Mixed Bank is subject to a partial transfer under the SRR, it is for the authorities to decide whether to transfer client money and/or assets to a private sector purchaser or bridge bank. Where they choose not to do so, it is not clear in the Second Consultation Document whether the BAP will be modified to accommodate the SAR objectives in relation to Mixed Banks and clarity would be welcomed in this regard. It would, however, appear that:

(a) for those residual companies which have retained a business involving the holding and safeguarding of client assets or client money, the SAR would be most appropriate and the application of the BAP should be modified to accommodate the relevant SAO; and

(b) for those residual companies which have not retained a business regarding the holding and safeguarding of client assets or client money, the BAP would be the most appropriate tool, and it should be clarified that the SAR modifications should not apply.

2.2.3 *Conflicting Objectives*

2.2.3.1 The statement in Box 2A of the Second Consultation Document that the pursuit of the objective set out in Section 99(2) (*Objectives*) of the Banking Act would involve no payout of estate or client assets is, in our view, fallacious. In this regard, we draw your attention to the comments made by the City of London Law Society in paragraph 13 of their comments on Part 2 (*Bank Insolvency*) and Part 3 (*Bank Administration*) of the Banking Bill[3] where it provides that the transfer of deposits to a third-party institution will likely require the transfer of equivalent assets; such assets may or may not be provided by the Financial Services Compensation Scheme.

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[3] See http://www.citysolicitors.org.uk/FileServer.aspx?oID=488&lID=0

3. BUSINESS RESOLUTION OFFICERS

3.1 Overview

3.1.1 The legislative changes proposed by HM Treasury to address the difficulties associated with winding-down large and complex investment firms centre on the appointment of a BRO. The BRO would be a director of the investment firm to whom

> the boards' collective responsibility for resolution could be delegated and who would be responsible for coordinating and overseeing the implementation of the resolution process.[4]

The BRO would have an important role to play in the investment firm's resolution. It would be responsible for, *inter alia*, drawing up business resolution plans pre-insolvency and implementing those plans upon the investment firm's failure.

3.2 Question 16: Do you have views on the coverage or detail of the BRO's responsibilities as outlined here?

3.2.1 If a BRO is to be appointed to an investment firm, the FMLC recommends that the role of the BRO should be clearly defined. Moreover, the FMLC is largely convinced by the arguments put forward by those who believe that the role of the BRO should be limited to overseeing the preparation and ongoing maintenance of the firm's resolution plan. Preparing for an investment firm's failure and instigating its ultimate resolution is likely to be a matter of systemic importance. With this in mind, careful consideration should be given to the interaction of the BRO with the board of directors in both an active trading context and a pre-insolvency context. Thus, specific responsibilities should be preserved for the collective expertise of the firm's board of directors. The board of directors should, for example, have a prominent role in the initial design of the resolution plan and it should be the board of directors collectively that decide when to implement the plan.

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[4] Paragraph 3.12 of the Second Consultation Document

4. RING-FENCING BUSINESS AREAS

4.1 Overview

4.1.1 The Second Consultation Document proposes that an investment firm should, in the two to three week period prior to becoming subject to insolvency proceedings (i.e. Phase I), carry out internal resolution actions with the objective of facilitating an orderly wind-down. One notable resolution action is the proposal that, during Phase I, firms should ring-fence safer parts of their business from exposures to more risky business areas (the "Ring-fencing Proposal").

4.2 Question 21: What are the obstacles to implementing investment firm resolution plans as suggested in this document?

4.2.1 Requiring failing investment firms to comply with the Ring-fencing Proposal is a matter of policy in respect of which the FMLC does not express a view. The Committee does, however, recommend that any obligation to comply with the Ring-fencing Proposal should be cognisant of the "Special resolution objectives" set out in Section 4 of the Banking Act and Chapter 3 of the Banking Act, Special resolution regime: Code of Practice (the "Code"). In particular, regard should be had to the objective of protecting and enhancing the stability of the financial systems of the United Kingdom (the "UK") which is concerned with protecting "the stable functioning of the systems and institutions (including trading, *payment* and infrastructure)"[5] (emphasis added) which support the efficient operation of financial services and markets.

4.2.2 It is important that the proposals for investment firm resolution plans, including the Ring-fencing Proposal, take account of the overriding need for the non-discretionary element of payment systems to remain intact. As long as a payment request is "valid" and the payment member has "sufficient liquidity", it will be processed by the payment system operators that are contracted to the UK's Payments Council (the "Payment Systems Operators").

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[5] Paragraph 3.4 of the Code

The manner in which payments are currently processed by Payment Systems Operators does not and cannot take account of the type of payment (i.e. whether or not it is in respect of a risky business area) being made.

4.2.3 Any attempt to protect a deposit-taking institution from the activities of a more risky affiliate should make full use of established structures which have as their object the protection of the overall integrity of the UK's payment systems. For example, in circumstances where an investment bank and a deposit-taking institution are a member of the same group and a member of a payment system, the Payment System Operators have discretion and, in certain circumstances, are required to suspend members when the integrity of their payment system is threatened. This method of suspension could be used by the authorities as part of any package of measures adopted to protect the assets of deposit-taking institutions.

5. ALLOCATING SHORTFALLS IN CLIENT OMNIBUS ACCOUNTS

5.1. Overview

5.1.1. It is common practice for client assets to be held by an investment firm in an omnibus account with a third party without differentiation as between one customer's holding and that of another. The omnibus account operates on the principle that each client's redelivery rights are fungible.

5.1.2. There is no settled principle of law which specifies how, on the insolvency of an investment firm, the shortfalls attributable to an omnibus account are allocated. Market practice often dictates that shortfalls should be borne *pro-rata* by clients in accordance with their percentage holding of the relevant securities and, generally, the contractual arrangements governing the relationship between the investment firm and the individual clients would expressly provide for such an approach. In the absence of such a provision, an affected client may, in light of an investment firm's failure, seek to rely on the complicated equitable "tracing" rule in an attempt to retake legal title to its *entire* percentage holding of the securities.

5.2. Question 35: Should the Government look to provide clarity over how shortfalls in client asset omnibus accounts are treated on insolvency?

5.2.1. The FMLC acknowledged, in its Original 144 Paper, that there was uncertainty in the wholesale financial markets as to how shortfalls would be apportioned in an omnibus client account following an investment firm's insolvency. Whilst the FMLC suggested that the uncertainty could be addressed by the market itself through the consistent use of clear contractual provisions, the Committee recognised that there may also be a need for regulatory or statutory clarification.

5.2.2. Since the publication of the Original 144 Paper, the Geneva Securities Convention has been adopted by diplomatic conference. The Geneva Securities Convention is an

> international instrument aimed at promoting internal soundness and cross-border system capability by providing the basic legal framework for the modern intermediated securities holding system.[6]

The protection of persons acquiring or otherwise holding intermediated securities is a key objective of the Geneva Securities Convention.

5.2.3. HM Treasury provides, in the Second Consultation Document, that the Government will continue to support the initiatives propounded in the Geneva Securities Convention and those set out in the much anticipated Securities Directive which is likely to be proposed by the European Commission later in 2010.[7] If clarification is to be provided on how shortfalls in client omnibus accounts are allocated, the FMLC recommends that regard is had to Article 26 (*Loss sharing in case of insolvency of the intermediary*) of the Geneva Securities Convention. Article 26 is supportive of the market practice referred to in paragraph 5.1.2 above and provides that, in the case of a group of account holders, any shortfall shall be borne by the account holders to whom

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[6] See "Background to the UNIDROIT Convention on Substantive Rules for Intermediated Securities" at http://www.unidroit.org/english/conventions/2009intermediatedsecurities/overview.htm.

[7] See paragraph 4.24 of the Second Consultation Document.

the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

6. CUSTODIAN'S RIGHT OF LIEN OVER CLIENT ASSETS

6.1 Overview

6.1.1 As highlighted above, client assets held by an investment firm are often pooled and are generally held in an account with a third-party custodian rather than in an account with the investment firm itself. In such instances, the investment firm often grants the custodian a right of set-off, a lien or some other form of security interest over the assets recorded in the account in respect of its indebtedness to the custodian. Clients are prevented from accessing their assets until such indebtedness is discharged.

6.2 Question 46: Should firms that manage client assets be required to obtain letters from custodians stating that there are no setoff and liens over client assets in respect of liabilities owed in a principal capacity by the firm?

6.2.1 The FMLC's Original 144 Paper raised the issue as to whether investment firms should require third-party custodians to waive any security interest, lien or right of set-off (to the extent permitted by law) over assets recorded in a client account with respect to liabilities owed by the investment firm in a principal capacity. In a similar vein, proposal 19 (*Change the regime regarding custodians' right of lien over client assets*) of the Second Consultation Document suggests that investment firms should seek comfort for their clients in the form of a "letter" from custodians stating that the custodian has no lien or right of set-off over client assets in respect of liabilities owed by the investment firm in its capacity as principal. Subject to paragraph 6.2.2 below, the FMLC is supportive of proposal 19 but recommends that it only applies to client assets held in an account with a *third-party* custodian where a lien or right of set-off is used as a means of reducing the custodian's credit exposure to the investment firm. The proposal should not apply to client assets held directly with the investment firm where

the lien or right of set-off is granted to the investment firm in respect of the client's own indebtedness.

6.2.2 Contractual comfort as to the non-existence of a right of set-off, lien or other security interest over client assets could come in many forms (e.g. a provision in the standard terms and conditions governing the account or a provision in the agreement appointing the third-party custodian) and the FMLC recommends, therefore, that the contractual comfort required by proposal 19 is not restricted to that which is provided in "letter" format only.

6.2.3 The FMLC acknowledges that it will be difficult, if not impossible, to obtain contractual comfort from custodians based in particular jurisdictions (e.g. Russia) and that any rule or regulation encompassing proposal 19 would need to take account of such impasse. The Original 144 Paper suggested that those jurisdictions where contractual comfort was unattainable could be clearly identified to the client so that it is aware that its assets could be made available to the custodian in respect of the investment firm's liabilities. The Second Consultation Document is cognisant of the FMLC's suggestion in this regard.

7. ESTABLISHMENT OF A CLIENT ASSETS TRUSTEE

7.1 Overview

7.1.1 On the insolvency of an investment firm which holds client assets, the Second Consultation Document proposes that a CAT is appointed by the court alongside the administrator. The CAT and the administrator would be obliged to cooperate with each other. The CAT would be appointed to look after the interests of client money and asset holders and would be required to expedite the return of such assets post-insolvency. It is intended that unencumbered client assets would be released as quickly as possible while encumbered assets would be held until the administrator is satisfied that they are not required to satisfy the client's indebtedness to the general estate. Where the value of encumbered assets significantly exceeds the value of secured liabilities, the Government believes that, in order to maintain liquidity in the markets, the

CAT should prioritise the return of the excess money and assets (the "Excess") to clients.

7.1.2 The establishment of a CAT is intended to address the difficulties faced by administrators of investment firms in protecting and promoting the interests of both the general creditor pool and those of clients who are owed money or assets by the investment firm as such interests may, at any given time, be conflicting. The conflict of interests is particularly acute where the client money or assets is secured in favour of the investment firm in respect of the client's indebtedness to the investment firm.

7.2 Question 55: Do you agree with the proposal to establish a CAT? Should the Government favour alternative measures for improving client outcomes, such as the proposal in Chapter 2 to amend the legal duties of administrators to require them to prioritise the return of client money and assets?

7.2.1 In the Original 144 Paper, the FMLC had yet to form a view as to whether the prioritisation of the return of client assets would be best undertaken either (i) as an additional or overriding aim of the administrator, or (ii) by a newly created special insolvency officeholder such as the CAT which is outside the administration process. The FMLC examined, in the Original 144 Paper, the arguments for and against each of the two propositions.

7.2.2 The Committee has reconsidered HM Treasury's proposal to establish a CAT and has determined that this is a policy initiative which is outside of its remit. For that reason, the FMLC does not purport to express a view as to whether or not it is appropriate to appoint a CAT to an insolvent investment firm which holds client money and/or assets. The FMLC considers it important, however, to highlight and, in part, reiterate some key legal uncertainties arising out of this proposal which have yet to be adequately addressed in the Second Consultation Document.

(a) Mutual Cooperation

The Second Consultation Document acknowledges that there will be difficulties in having a CAT appointed to an insolvent investment firm in addition to an administrator. The identification of encumbered assets is used as an example where differences of opinion may arise, particularly, when both the administrator and the CAT assert a claim over the same assets for their respective creditor pools. On that basis, it is proposed that both practitioners are subjected to a mutual duty to cooperate with each other although, in a somewhat contradictory fashion, their ability to challenge, through the court, the decisions of the other is preserved. HM Treasury is aware that care will need to be taken to ensure that any legislative developments in this regard address the potential conflicts that are likely to arise and in doing so, the FMLC recommends that each of the issues below are given due consideration.

(i) Hierarchical Structure

Rather than having an administrator and a CAT working independently in a parallel manner, the FMLC suggests that a mini-hierarchical structure should be considered as an alternative. This could be achieved through legislation (or regulation) which dictates the duties of the administrator and the CAT and the order of priority in which those ought to be carried out. The roles of the CAT and the administrator are not conclusively defined in the Second Consultation Document and further consideration needs to be given to those duties which are of interest to creditors and clients of the investment firm and, therefore, could be undertaken by either practitioner (e.g. who identifies the encumbered client money and assets).

(ii) Administrator and CAT – appointment from the same firm or different firms?

The Committee recommends that the administrator and the CAT should be appointed by the same firm as established communication lines would already be in place which would facilitate an effective flow of information between the two practitioners. If appointed by the same firm, it is unlikely that one practitioner would challenge, in a contentious manner, the decisions of the other and it is more likely that directions would simply be sought, in a harmonious way, from the court. Such an approach would also encourage both practitioners to work closely together in ensuring an orderly and efficient wind-down of the insolvent investment firm to which they have been appointed which would have the knock-on effect of reducing the costs associated with the firm's resolution.

(iii) Information Flow

It is vital to the proper performance of the CAT's duties that it has access to all information which is relevant to (1) the investment firm's holding of client money and assets including details of any security interest or other encumbrance which the investment firm has been granted over such client money and/or assets; and (2) the liabilities which are owed by individual clients to the investment firm and those which have yet to crystallise (e.g. open derivative positions and contingent obligations). As highlighted above, information would flow more readily if the administrator and CAT were appointed by the same consultancy firm. In any case, the FMLC recommends that legislative structures are put in place to endorse and facilitate information sharing between both practitioners as it would be overly burdensome for clients to have to prove their claims twice.

(b) Derivative Positions

In order to be able to ascertain the extent to which the value of secured client money and assets exceeds the value of secured liabilities, it is imperative that the CAT is able to determine the value of secured liabilities to begin with. This process is frustrated by the regime which operates in relation to the termination of derivatives positions. It is usually the non-defaulting party to a derivatives contract which has the right but not the obligation to terminate all derivative transactions. In addition, it is the non-defaulting party that would usually be empowered to value the net position outstanding post-termination (the "Close-out Amount"). There is no specified time period within which the non-defaulting party is obliged to terminate the transactions and whilst the transactions remain "live" the CAT will be unable to return any portion of the encumbered assets because the Close-out Amount attributable to such transactions can fluctuate daily, at times in a fairly volatile manner, up until valuation which should occur as soon as reasonably practicable post-termination. Possible solutions to this anomaly are considered in paragraph 9 (*Termination of Derivatives Contracts*) below. Once all "live" derivative contracts have been terminated, a structure also needs to be put in place to ensure that details of the Close-out Amounts are transmitted to the CAT once they have been agreed with the administrator.

(c) Liability/Costs of CAT

It is envisaged in the Second Consultation Document that the CAT would be able to make net distributions (i.e. a distribution determined on the basis of both a client's debts to the insolvent firm and the amount of money/assets held by the investment firm for that client) without personal liability. For this to be achieved, it is proposed that the CAT should be indemnified from the trust property in circumstances where it has acted in good faith but has still been held

liable for loss.[8] Whilst the emphasis is very much on the swift return of client assets, establishing liability for loss is often a time-consuming process. With this in mind, it is difficult to see how the CAT could be indemnified from the trust property at a time after which such trust property has already been distributed. The same issue arises to the extent that costs associated with the appointment of the CAT are to be funded from trust property held by the investment firm as such costs will only be fully known when the CAT has completed the tasks for which it has been appointed (i.e. after client money and assets have been returned). Further consideration needs to be given to the practicalities of remunerating and indemnifying the CAT and whether it is envisaged that the CAT will have an unsecured cash claim against each client through which it must, effectively, seek to claw-back amounts which it has previously distributed. If this is the case, the CAT will be exposed to all the difficulties associated with such a process (e.g. enforcement problems, bad debts and time delays in receiving payment).

7.2.3 Regardless of whether or not the powers in Part 7 of the Banking Act are used to create a CAT, the FMLC considers the proposed SAOs to be an important advancement in the insolvency regime of investment firms which can, if necessary, operate independently of a new CAT regime.

8. SEGREGATION OF INVESTMENT FIRM AND CLIENT ACCOUNTS AT CLEARING

8.1 Overview

8.1.1 Client positions held by CCPs are often co-mingled with "the assets of other clients and the investment firm's own positions in a house account".[9] Co-mingling assets in this way exacerbates the problems associated with identifying an individual client's holding and concern was expressed to this effect following LBIE's collapse in 2008. Unsegregated accounts, on the

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[8] Paragraph 5.27 of the Second Consultation Document

[9] Paragraph 6.56 of the Second Consultation Document

other hand, reduce clearing member's margining obligations to the CCP as positions may be netted together with the clearing member's proprietary business. This, in turn, reduces the client's margining obligations to the clearing member.

8.2 Question 73: Do you agree that there would be value in the introduction of an explicit requirement that CCPs offer facilities for members to segregate their business?

8.2.1 Whether or not CCPs are required to offer facilities to members for the segregation of their business from that of investment firms is a matter of policy in respect of which the FMLC does not express a view. However, if such a requirement is imposed on CCPs, regard should be had to Part 7 of the Companies Act 1989 and the related regulations (together, the "Part 7 Provisions") which already require a CCP which is a recognised clearing house to provide for the separate netting and close-out of all client and house positions on the default of a clearing member.

8.2.2 The Part 7 Provisions are, however, deficient in some respects. If policy in this area is being reviewed and reliance is to be placed on a modified version of the Part 7 Provisions, the FMLC recommends that these deficiencies are first remedied. "Client positions", for example, are defined in the Part 7 Provisions by reference to the Financial Services Authority's client money rules. This is unsatisfactory because it denies the protection of segregation to transactions which have been:

(a) entered into by overseas entities which are not subject to the UK's client assets regime (e.g. EEA institutions operating through 'passported' branches in the UK); or

(b) segregated by agreement between the investment firm and the client.

It would be preferable to adopt a more inclusive definition of "client positions" which would encompass all positions which are held for clients and those in respect of which the clearing member has agreed or is required by law to segregate.

8.2.3 Whatever the definition of "client positions", it is clearly important that the CCP's default rules enable the CCP to deal with a clearing member's insolvency expeditiously with a minimum risk of challenge from interested parties. It is, however, unclear, in the Part 7 Provisions, who is responsible for ensuring that transactions are correctly allocated as between the client and house accounts. There is concern that the allocation of transactions by CCPs would be open to challenge if it could be shown that transactions which should have been treated as client positions have not been treated as such. This risk of challenge would be removed or, at least, mitigated if the CCP was permitted to:

(a) place the onus on the clearing member to allocate transactions to the "correct" account; and

(b) provide that such allocation would be conclusive for the purposes of the CCP's default rules.

The CCP would, as a result, be in a broadly similar position to that of a bank holding money in a client account. In such instances, the bank is required to confirm that it will not exercise any rights of set-off, but it is not expected to verify that the money in the account is actually client money.

8.2.4 These shortcomings should be remedied in the Government's forthcoming review of the Part 7 Provisions and they should also be considered as part of the development of any broader obligation on CCPs to offer facilities for segregation of client and house positions.

9. TERMINATION OF DERIVATIVES CONTRACTS

9.1 Overview

9.1.1 Section 2(a)(iii) of the 1992 ISDA Master Agreement (Multicurrency – Cross Border)[10] provides that

> Each obligation of each party under Section 2(a)(i) is subject to (1) *the condition precedent that no Event of Default or Potential Event of Default has occurred and is continuing*, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement. (emphasis added)

In the initial period of uncertainty that exists after a party has defaulted, it is important that the non-defaulting party is protected and is not required to make scheduled payments or deliveries as they fall due as this would have the adverse effect of increasing, at the worst possible time, its credit exposure to the defaulting party. Such protection is afforded by Section 2(a)(iii) of the ISDA Master Agreement (the "Agreement") although there are no precise delimitations as to its use. Whilst the non-defaulting party has no obligation to perform its payment or delivery obligations under the Agreement due to the failure of the condition precedent, the defaulting party will be obligated to continue making scheduled payments and deliveries as they fall due and will even be required to pay default interest in the event of non-payment on a scheduled payment date.

9.1.2 It is perhaps not surprising, given that Section 2(a)(iii) is drafted as a condition precedent (and not, for example, as a suspensive clause), that the Agreement does not specify a time after which, if the condition precedent remains unfulfilled, the condition precedent falls away (or is deemed fulfilled)

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[10] Most transactions are still covered by the 1992 ISDA Master Agreement, but the market is increasingly moving towards the 2002 ISDA Master Agreement. See paragraph 7.6 of the Second Consultation Document.

and the non-defaulting party is then obliged to perform.[11] It is also the case that Section 6(a) of the Agreement[12] confers a right, but *not* an obligation, on the non-defaulting party, by designating an Early Termination Date (as defined in the Agreement), to terminate all transactions under the Agreement following the occurrence of an event of default with respect to its counterparty. These two facts taken together mean that the counterparty may never be required to perform any further obligations under the Agreement, unless an Early Termination Date is subsequently designated in relation to it as a defaulting party, for example, due to its own insolvency.

9.1.3 In practice, therefore, Section 2(a)(iii) would appear to prevent a liquidator or administrator from recovering the positive net mark to market value it would otherwise be entitled to recover from a non-defaulting party if an Early Termination Date was designated under Section 6(a) of the Agreement.[13]

9.1.4 Investment firms will, at any given time, often have a multitude of derivative trades documented under their Agreements, both simple ("vanilla") and complex. The Second Consultation Paper acknowledges that this is the case and focuses on the uncertainty which Section 2(a)(iii) causes for the administrators and unsecured creditors of failing investment firms.

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[11] In the recent case of *Marine Trade SA v Pioneer Freight Futures Co Ltd* [2009] EWHC 2656 (Comm) [61], Flaux J interprets Section 2(a)(iii) as a "one time" provision, meaning that if the condition precedent is not satisfied on the due date of the relevant obligation of the non-defaulting party, then no obligation arises. This appears, however, to be at odds with the general understanding in the market that if the condition precedent of Section 2(a)(iii) is fulfilled at some point after the original due date (which may, depending on the nature of the defaulting party's default, be an actual or virtual impossibility), then the non-defaulting party is obligated to perform the relevant obligations. Flaux J expresses the view that, if that is the intention, then the document should state that explicitly. It is not clear, though, why that view is more compelling than the view that express words should not be necessary where the sensible economic result is clear, as evidenced by the predominant market view (which is generally supported by "textbook writers", as Flaux J acknowledges in his judgment). In other words, it seems equally, if not more compelling, that express words should only be required where the intent is for the provision to operate as a "one-time" provision, given that this is an odd result economically.

[12] Section 6(a) governs, by reference to the events of default in Section 5(a) of the Agreement, the circumstances in which a non-defaulting party may designate an Early Termination Date in respect of all transactions under the Agreement or in which, if the parties have so elected, an Early Termination Date may occur automatically. The latter case (automatic early termination) is relatively rarely elected, especially in relation to an English-incorporated party and so for convenience references in this paper are only to the designation of an Early Termination Date. Notwithstanding the above, the analysis of the current point is the same, whether an Early Termination Date is designated or occurs automatically.

[13] Obligations that would have been required to be performed by the non-defaulting party under Section 2(a)(i) of the Agreement but for the condition precedent in Section 2(a)(iii) are included in the final close-out calculation, as well as the mark-to-market value (effectively, the replacement cost) of all of the terminated transactions and, of course, amounts owed by the defaulting party that were due and unpaid as of the Early Termination Date.

Administrators of failing investment firms do not know whether the firm's non-defaulting counterparties will *ever* designate an Early Termination Date. On that basis, there is also uncertainty as to whether or not the value of open positions will ever be realised. Whilst such uncertainties exist, administrators also face difficulties in trying to establish and maintain effective hedge positions for the failing investment firms to which they are appointed.

9.2 Question 80: Do you agree that regulatory or legislative action is not required if a suitable market solution is reached with respect to the issue of terminating derivatives contracts?

9.2.1 The Second Consultation Document sets out, in paragraph 7.12, three possible solutions to the problems caused by Section 2(a)(iii), each of which has been considered by HM Government and is identified below:

(a) legislating for automatic termination of all transactions under the Agreement in the event that a party becomes subject to the appointment of an administrator;

(b) legislating for the termination of contracts by counterparties within a certain time period; or

(c) encouraging the market to develop a solution that preserves any perceived benefit of Section 2(a)(iii) while providing sufficient certainty to the administrators as to the eventual timing of early termination and therefore realisation of the value of open transactions (the "Market Solution").

9.2.2 HM Government highlights its preference, in paragraph 7.13 of the Second Consultation Document, for the Market Solution and suggests that any such solution should have the effect of promoting "a greater degree of certainty with respect to derivatives transactions terminations". The FMLC agrees with HM Government in this respect for the reasons set out below.

9.2.3 The International Swaps and Derivatives Association, Inc. ("ISDA") is often seen as the voice of the international derivatives market. The Agreement consistently features in the documentation of derivatives transactions and is,

therefore, of fundamental importance to the derivatives industry as a whole. On the basis of the foregoing, it is imperative that the derivatives industry, as opposed to the legislature or the financial services regulator, resolves any uncertainties caused by key provisions of the Agreement which it pioneered through ISDA. It would, therefore, be logical for ISDA to pre-empt any legislative or regulatory intervention and to lead the market in proposing solutions to the issues highlighted in paragraph 9.1.4 above. The FMLC has briefly considered two alternative suggestions (below) as Market Solutions but defers to ISDA on the question as to which, if any, of these solutions is both feasible and desirable or whether some variant or alternative to these solutions would be the best approach.

9.2.4 First, it is notable that Section 2(a)(iii) is customarily modified in Australia by the inclusion of the following additional termination event (the "Proposed ATE") in the schedule to the Agreement:

> An Event of Default occurs with respect to a party ("Party X"), Party X has satisfied all its payment and delivery obligations under Section 2(a)(i) with respect to all Transactions and has no future payment or delivery obligations to the other party ("Party Y") whether absolute or contingent under Section 2(a)(i) (the "First Condition"), and Party Y refuses to make a payment to Party X based upon the condition precedent in Section 2(a)(iii) (the "Second Condition"). For the purposes of the foregoing Termination Event, the Affected Party shall be Party X.[14]

9.2.5 The Proposed ATE entitles the defaulting party, in the event of non-payment by the non-defaulting party, to terminate all transactions under the Agreement provided that the defaulting party has no future payment or delivery obligations thereunder. If a non-defaulting party does not want to continue trading with an insolvent investment firm, the non-defaulting party will, effectively, be required to terminate all transactions under the Agreement.

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[14] See *Enron Australia v TXU Electricity* [2003] NSWSC 1169 and *Enron Australia Finance Pty Ltd (in liquidation) v Yallourn Energy PTY Ltd* [2005] NSWSC 56, app [2005] NSWC 326.

With the Proposed ATE, a non-defaulting party will eventually be liable to account to the defaulting party for the positive net mark-to-market value of the terminated transactions under the Agreement.

9.2.6 The drafting of this additional termination event has yet to be perfected. The FMLC is aware that it has been the subject of intense scrutiny by the Australian courts where it became apparent that clarity was needed to ascertain whether the payment or non-payment of default interest could impact the satisfaction of the First and Second Conditions.[15] The FMLC suggests, however, that it offers a useful starting point for addressing the uncertainties highlighted by HM Government in paragraphs 7.5 to 7.14 of the Second Consultation Document. The FMLC suggests that a modified version of the Proposed ATE, adjusted to reflect the commercial agreement with regard to default interest, could be used to form the basis of a Market Solution.

9.2.7 Secondly, a Market Solution could be achieved through an amendment to Section 6(a) of the Agreement which would prescribe a time-period[16] within which a non-defaulting party, after the occurrence of an event of default with respect to its counterparty, must terminate all transactions under the Agreement.

9.2.8 Protocols are often used by ISDA to supplement or amend existing ISDA documentation and the FMLC considers that a "Section 2(a)(iii) Protocol" could be used to achieve either of the Market Solutions proposed above. An ISDA protocol allows each adherent to the protocol to amend its bilateral

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[15] In *Enron Australia Finance Pty Ltd (in liquidation) v Yallourn Energy PTY Ltd,* it was held by the Court of Appeal in New South Wales that Party X did not need to pay interest to Party Y to satisfy the First Condition and Party Y did not need to pay interest to defeat the Second Condition.

[16] *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 et seq. (JMP) (jointly administered) one year was considered too long a delay in designating an Early Termination Date when facing a counterparty in U.S. bankruptcy proceedings. By delaying so long, the non-defaulting party was deemed by the US Bankruptcy Court to have waived its right to terminate. It is worth bearing in mind, however, that this part of the US Bankruptcy Court's judgment was concerned with how long the statutory safe harbour for early termination and netting under the US Bankruptcy Code is available to a creditor after the commencement of proceedings under the US Bankruptcy Code. It was not concerned specifically with Section 2(a)(iii) or its enforceability, although in a separate passage in the same judgment the judge indicates his view, with little supporting analysis, that the condition precedent in Section 2(a)(iii) is not enforceable under the US Bankruptcy Code. In other words, it would appear, although the judgment is somewhat cryptic in this regard, that even a short time limit would not rescue the enforceability of Section 2(a)(iii) under US insolvency law.

ISDA documentation with each other adherent to the protocol, eliminating the need for dozens, if not hundreds, of separate bilateral negotiations while also ensuring a relatively uniform result across the market.[17] Parties also, of course, remain free to agree bilaterally to amend their Agreements based on the standard language set out in any "Section 2(a)(iii) Protocol" (perhaps with certain adjustments to suit their specific circumstances).

9.2.9 Whilst adherence to an ISDA protocol is voluntary, parties may, in order to promote a Market Solution proposed by ISDA, be encouraged or incentivised by regulatory action to adhere to a "Section 2 (a)(iii) Protocol". In this way, the legislative option, which HM Treasury indicates is not the preferred approach, could be avoided. It would remain, however, a possibility if market participants were slow to adopt the Market Solution.

[17] Some ISDA Protocols allow some elections to be made by an adherent when adhering, so that, to the extent that there is variation in the elections made, the Protocol does not ensure a wholly uniform result across the market.

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[18] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only. Whilst the Bank of England, the Financial Services Authority and HM Treasury participate in the FMLC, the views expressed in this paper are not necessarily those of the three institutions.