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Insolvency and Financial Risks in Derivatives Transactions

Navigating Recent Developments in Bankruptcy Litigation and New Regulatory Protections Against Insolvency Risks

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INSOLVENCY AND FINANCIAL RISK IN DERIVATIVES TRANSACTIONS

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April 17, 2012

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- Lehman Brothers and MF Global have raised fundamental questions for participants in the derivatives market.
  - Lehman challenged the perception that derivatives trades would be given broad safe harbor treatment if a party went into bankruptcy.
    - Structures are more complex than when the safe harbors provisions were adopted.
    - Lehman was the dealer, not the customer.
  - Dodd Frank was enacted as a reaction to the financial crisis triggered by the Lehman bankruptcy.
    - In formulating a regulatory structure for the over-the-counter derivatives market, legislators worked from the most convenient model available at the time.
    - Structure is based to a great extent on the regulated futures market, which was considered very safe.
  - MF Global was a regulated futures broker. The MF Global case has cast doubt on the extent to which market participants are protected under a futures-like structure.

Lehman Brothers – Current Status of the U.S. Insolvency Proceedings

- The Chapter 11 Bankruptcy Cases (LBHI and non broker/dealer affiliates)
  - LBHI and its domestic U.S. subsidiaries in chapter 11 bankruptcy confirmed a plan of reorganization in late 2011
  - The plan of reorganization went "effective" towards the end of the first quarter 2012.
  - Initial distributions to creditors are anticipated to be made ***today*** (a mere 1310 days since the bankruptcy case was filed).
  - Total initial distribution to be more than $22 billion.
  - Estimated initial distributions percentages vary widely based upon the type of claim: low of 2% to a high of 100%.
  - Factors affecting the amount of the payout include: (i) the Lehman entity against which you held a claim, (ii) whether you held a guarantee claim or a direct claim, (iii) whether your claim was entitled to contractual seniority or if your claim was contractually subordinate (subordinate creditors will generally receive nothing from the Lehman chapter 11 cases).

Lehman Brothers – Current Status of the U.S. Insolvency Proceedings (continued)

- The SIPA Proceeding (LBI, the broker/dealer)
  - Most accounts transferred to Barclays in September/October 2008
  - Certain kinds of accounts were not transferred and are subject to resolution in the SIPA proceeding
    - These include, particularly, more complicated accounts with differing kinds of assets and different kinds of financing. The acquiror (Barclays) did not want to assume these accounts.
  - For those account holders that were not transferred, some (but not all) have received a distribution from SIPA (capped at $500,000).
  - All remaining account holders are subject to the liquidation and the claims proceeding.
  - Trustee has substantial assets available for distribution – about $20 billion.
  - Complicated claims are also being litigated – principally the intercompany relationship between LBI and LBIE (the English entity).
  - Distributions to customers and creditors will likely be delayed until resolution of the LBIE claim.
  - Customers ***may*** recover in full; creditors will be substantially impaired – secondary pricing for claims is about 10% of face value.

Lehman Brothers – Some considerations for the future

- Credit quality is a valuable asset to be considered and priced
  - Range of recoveries in the Lehman chapter 11 cases shows this:
    - Creditors of Lehman Brothers Derivatives Products will receive a 100% initial distribution
    - Creditors of Lehman Brothers Special Finance will receive a 21% initial distribution
- Consideration of credit quality alone is insufficient to protect from loss
  - Creditors of Lehman Brothers Derivatives Products still had to wait for 3.5 years to get paid
- Parent guarantees improve recovery, but have limitations
  - When the parent files for bankruptcy, collection on the guarantee will be stayed
  - A guarantee is subject to attack in a bankruptcy: LBHI senior claims are estimated to receive 21%, whereas LBHI senior guarantee claims will receive about 13%.
- Adequate collateralization of exposure continues to be key
  - While the bankruptcy safe harbors have been tested in many ways during the Lehman bankruptcy (more on that below), the core acts of agreement termination and realization on pledged collateral were not seriously challenged.
- Third party credit enhancement – such as through a credit default swap, letter of credit, or similar mechanism – continues to be important.

Lehman Brothers – Update on recent swap litigation – the *UBS* case

- Background:
  - After LBHI filed for bankruptcy (9/15/08) but before LBI files, UBS AG sends a termination notice on a swap to LBI
  - In Valuation Notice, UBS both sets off against posted collateral posted to UBS AG and sets of excess collateral against claim LBI owes to an affiliates under section 5(a) of the ISDA
  - Affiliate was not a party to the ISDA – 5(a) provides a general right of setoff with respect to affiliate debts of the non-defaulting party
  - LBI trustee asserts that the affiliate setoff was improper and violated the terms of the Bankruptcy Code
  - UBS responds that the setoff was proper and that the exercise of its rights was protected under the safe harbor

Lehman Brothers – the *UBS* case (cont.)

- The Court's ruling on enforceability of contractual setoff and the impact of the Bankruptcy Code safe harbor:
  - The Court determines that, as a matter of applicable New York state law, the contractual provision providing for a "triangular setoff" – i.e., setoff of debt owed to a debtor of a claim of an affiliate against that debtor is enforceable.
  - The Court states that *outside of bankruptcy* the provision would be enforced.
  - Upon bankruptcy, the Court holds that the rules change.
    - Setoff is only permissible where there are *mutual* debts and claims – and parties *cannot* contract around the Bankruptcy Code requirement of mutuality.
    - Court further holds that the Bankruptcy safe harbors do not alter this result – i.e., notwithstanding the protections of the safe harbor, in a bankruptcy proceeding, a party must still establish mutuality to exercise setoff rights

Lehman Brothers – the *UBS* case (cont.)

- Analysis of the decision:
  - The swap safe harbor (section 561) protects the right to "offset arising under or in connection with one or more swap agreements" and further provides that these rights will not be "stayed, avoided, or ***otherwise limited by operation of any provision of this title*** or by any order of a court …"
  - The Court recognized that the UBS right would be valid and enforceable outside of bankruptcy
  - Only limitation is imposed by the mutuality requirement of section 553 of the Bankruptcy Code
  - Section 561 explicitly states, however, that the setoff right is not to be "limited by any provision of the Bankruptcy Code."
  - Very difficult to see how imposing the mutuality requirement of section 553 does not limit the triangular setoff that the Court determined was enforceable outside of bankruptcy under applicable New York law.

Lehman Brothers – the *UBS* case (cont.)

- The case law background:
  - The decision relied upon two prior cases limiting "triangular setoffs" in bankruptcy
    - The first case addressing this was the *Semcrude* case
      - *Semcrude* dealt with a common creditor offsetting a debt it owed to one debtor against a claim it was owed by another affiliated debtor.
      - The *Semcrude* court was very clear, however, that it was not addressing any bankruptcy safe harbor provisions. On a motion to reconsider, the Court held that because the safe harbors were not originally raised, such argument was waived by the creditor.
    - The second case was Judge Peck's own decision in *Swedbank*
      - *Swedbank* was a very different case than UBS.
      - Swedbank was a party to an ISDA with LBHI and LBHI also held an unrelated deposit account at Swedbank.
      - Post-bankruptcy filing, LBHI inadvertently made a deposit into this account and Swedbank tried to setoff that deposit.
      - Mutuality in Swedbank was pre- versus post-petition.

Lehman Brothers – the *UBS* case (conclusions)

- *UBS* is a problematic limitation on safe harbor rights
  - The language of the Bankruptcy Code suggests that what UBS did is permissible
- The potential scope of the opinion (if followed) could be significant:
  - Affiliate setoffs under the form ISDA appear to be cut off in the SDNY
  - Potentially broader consequences, including on master netting agreements that purport to permit setoff under multiple contracts between multiple affiliates on either side.
- Subsequent courts may limit *UBS* to the facts of the case
  - Only setoff right arose under section 5(a) of the ISDA
  - The UBS affiliate was *not* a signatory to the ISDA
  - While this may become a significant distinction later, it was not addressed by the Court
- Initial suggestions include:
  - Obtain signatures from all affiliates on an ISDA
  - Include cross-collateralization provisions in favor of affiliates – i.e., defeat the setoff problems by avoiding setoff altogether

- *MF Global* – Some updates on case status
- Background:
  - MF Global, Inc. was a regulated broker/dealer and a futures commission merchant
  - Market fear concerning its exposure to European sovereign and bank debt lead to a liquidity crisis
  - MF Global tries to sell itself, but the purchaser backs out, purportedly because of a reported shortfall in customer segregated funds
  - On October 31 SIPC applies to commence a liquidation proceeding, which is commenced that day
  - Immediately prior to the commencement of the SIPA proceeding, the U.S. holding company filed for chapter 11 bankruptcy
  - The English unit has also been placed into a separate administration proceeding

MF Global (cont.)

- Major activities and issues in the SIPA case to date:
  - Account transfers:
    - Many commodity accounts transferred within days after the insolvency proceeding commenced; up to 60% of customer's collateral was transferred with accounts at this time.
    - Securities customers accounts were transferred in most cases by the end of the year, with some securities customers obtaining a full transfer of their securities at that time.
  - Distributions of property
    - Subsequent to commodity customer account transfers, a "true up" was made to customers trading on U.S. exchanges
    - True up distribution made without a resolved claims process
    - Trustee has subsequently sought authority to distribute additional moneys, but no resolution of this additional distribution at this time

- *MF Global* (cont.)
- Major activities and issues in the SIPA case to date (cont.):
  - Investigation:
    - Trustee has reported a $1.6 billion potential hole in the fund of customer property.
    - Unclear at this juncture how the trustee arrives at his figures given distributions to date and reported reserves.
    - Investigation is ongoing and includes directors and officers, counterparties and others. Little visibility into investigation at this date.
  - Disputes:
    - Money related to non-U.S. exchange traded futures has been caught up in English insolvency proceeding.
      - Unclear issues concerning when and how much may be recovered for customers
    - Ongoing disputes with parent company concerning relative rights of customers and parent to moneys
    - Other disputes asserted by certain customers

- *MF Global* (cont.)
- Initial observations concerning insolvency proceeding:
  - Trustee has made substantial steps towards liquidation
    - Account transfers and transfers of collateral have been rapidly accomplished
    - Remaining collateral will be transferred through the claims process
  - Litigation that has occurred is reasonably foreseeable in the context of a multinational financial institution with cross-affiliate trading relationships
  - Other litigation (against third parties) will begin to attempt to fill the "hole" in customer property
  - Weaknesses exposed by MF Global likely reflect weaknesses more associated with the regulatory system that governs going concerns than the system for unwinding insolvent enterprises
  - Additionally, no matter how strong the regulatory system, absent a government guarantee or public or private insurance system (both of which have their own potential limitations), there will be risk of loss
    - Continued focus not only on counterparty risk, but also on intermediary risk is important

- How does Dodd Frank change the analysis and management of insolvency risk with respect to over-the-counter derivatives transactions?

- Pre-Dodd Frank, analysis was based largely on Bankruptcy Code and bank insolvency law.
  - ✓ Bankruptcy Code:
    - Safe harbor treatment for swap agreements, forward contracts, commodity contracts, securities contracts, repurchase agreements and master netting agreements.
    - Safe harbors address (i) contractual termination provisions, (ii) transfers made before bankruptcy filing, and (iii) setoff of collateral against obligations.
  - ✓ Bank insolvency law:
    - Special treatment for qualified financial contracts – same products as the Bankruptcy Code safe harbor products.
    - Treatment similar to Bankruptcy Code safe harbor treatment, except for some limitations on right to terminate transactions and a requirement for retention of records of board approval.

- ✓ Bankruptcy Code amendments creating and enhancing safe harbors were intended to address systemic risk, but weren't sufficient.

- A key goal of Dodd Frank is systemic risk and preventing another financial crisis (and taxpayer bailout).
- Treatment of major market players: Volcker rule, swaps push-out provision, Orderly Liquidation Authority.
  - ✓ Volcker Rule (Dodd Frank Section 619) – prohibits proprietary trading by FDIC insured banks and their affiliates.
    - ❑ Prohibition much broader than derivatives.
    - ❑ Statutory provision with an effective date of July 21, 2012. Proposed regulation to "clarify" is several hundred pages. Over 17,000 comment letters received.
    - ❑ Regulatory and legislative push to rework the rule, delay effective date or clarify what will be required on July 21, 2012.

- ✓ Swaps push-out provision (Dodd Frank Section 716) – prohibits government assistance in the form of FDIC insurance, guarantees or access to the Fed window to swap dealers and major swap participants engaging in more "risky" swaps.
  - ❑ On March 30, 2012, the federal banking regulators clarified that the effective date of the swaps push-out provision is July 16, 2013, not July 16, 2012 as some market participants believed.
  - ❑ Legislative effort to broaden the scope of derivatives falling outside the swaps push-out provision passed the House Financial Services Committee on February 16, 2012.
- ✓ Orderly Liquidation Authority (Dodd Frank Title II) – orderly liquidation of systemically important financial institutions (SIFIs)
  - ❑ Can be applied to bank holding companies, nonbank financial companies that the Financial Stability Oversight Council (FSOC) has determined are systemically significant, companies primarily engaged in financial activities, and any subsidiary engaged in financial activities that is not an insured depository institution or an insurance company.

- On April 3, 2012 FSOC adopted a rule to guide determination of systemic significance. Factors include asset size, leverage ratio, derivatives liability in general, credit default swaps outstanding, debt to asset ratio.
- SIFIs must create a living will.
- Federal Reserve Board of Governors, Treasury Secretary and the regulator for a troubled company are involved in determining whether the orderly liquidation process should be invoked (and therefore which insolvency scheme is relevant).
- Insolvency structure under Orderly Liquidation Authority is similar to bank insolvency under the Federal Deposit Insurance Act. FDIC is in charge of the liquidation. Uses bridge entity (“good bank / bad bank”) approach.

- Counterparties on qualified financial contracts, including swap agreements, have preferential rights in an orderly liquidation, including termination under contractual provisions and netting.
    - Counterparties must wait one business day before terminating and netting qualified financial contracts to give the FDIC time to transfer qualified financial contracts to a bridge entity or an unrelated entity.
    - If the contracts are transferred to a bridge entity or an unrelated entity, counterparty cannot exercise termination and netting rights.
    - If FDIC transfers qualified financial contracts with a counterparty, it must transfer all of them – no cherry picking.

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- Swaps under Dodd Frank
  - Dodd Frank specifically regulates “swaps.” Swaps were viewed by many as one of the causes of the 2008 financial crisis.
  - Brief overview of Dodd Frank structure for swaps:
    - ✓ Presumption of clearing for swaps.
    - ✓ Cleared swaps
      - ❑ Mandatory clearing changes swaps from bilateral, individually negotiated contracts to a multi-step, multi-party process.
      - ❑ Central clearing entity is a party to all trades.
      - ❑ Clearing function and central clearing entity accessed through a clearing member.
      - ❑ Margin required as part of the clearing function. Margin is required by the central clearing entity. Clearing member may require more margin.

- Clearing member can’t accept margin for swaps unless registered with the CFTC as a futures commission merchant (FCM).
- Transactions subject to mandatory clearing must be executed on an exchange or a swap execution facility, unless no exchange or swap execution facility makes the swap available for trading.

✓ Uncleared swaps

- Swaps can be uncleared if no one accepts the swap for clearing or the end-user exemption applies.
- Uncleared swaps are bilateral contracts, but may be subject to some of the regulatory requirements under Dodd Frank.
- Uncleared transactions will continue to be relevant, even after Dodd Frank is fully implemented.
  - Non-standard transactions and innovations will be in the uncleared category.
  - Many transactions will fit end-user exemption, although end-user can opt to clear the transaction.

- Central clearing is intended to reduce systemic risk from failure of a major market participant.
  - ✓ Derivatives clearing organization (DCO) is counterparty to all transactions. Exposure to a single significant market participant is netted across all trades through that DCO.
  - ✓ Significant funds supporting the DCO.
    - ❑ Highly capitalized by clearing members.
    - ❑ Margin (initial and variation) required for each transaction.
  - ✓ Significant market participants (swap dealers, major swap participants) and infrastructure entities (DCOs, exchanges, swap execution facilities) are regulated and must adhere to CFTC/SEC rules.
    - ❑ CFTC's final business conduct rules for swap dealers and major swap participants were published in the Federal Register on February 17, 2012 (conduct with customers) and April 3, 2012 (internal conduct). SEC has not yet finalized rules.
    - ❑ Core principles for DCOs and swap data repositories published in the Federal Register on November 8, 2011 and September 1, 2011.

- What can go wrong under Dodd Frank structure for cleared swaps?
  - Failure of a DCO would have systemic implications.
    - ✓ Has the risk of an insolvent DCO been adequately addressed?
    - ✓ Should DCOs be a SIFIs?
  - Failure of an FCM
    - ✓ Bankruptcy Code amended by Section 724 of Dodd Frank so that cleared swaps are considered commodity contracts with respect to an FCM (or a DCO).

- ✓ Corresponding amendments to Part 190 were adopted by CFTC and published in the Federal Register on February 7, 2012.
  - ❑ Extends Bankruptcy Code and Part 190 treatment of futures/commodities to cleared swaps, including Part 190 provisions regarding transfer of positions to another FCM.
    - o Portability of positions is dependent upon segregation of margin, as margin will be needed to support the transferred contracts.
    - o July 2009 report by key sell-side and buy-side players on portability of positions and segregation of margin: "Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin."

- Protection of customer margin for cleared swaps
  - Dodd Frank requires customer margin to be segregated from FCM's own funds. How to implement margin segregation has been the subject of extended industry discussion.
  - CFTC held a roundtable on the issue of segregation of margin in October 2010.
  - In December 2010, CFTC issued an Advanced Notice of Proposed Rulemaking requesting comment on models for segregation of margin:
    - ✓ Physical segregation – DCO has no recourse to margin of a non-defaulting customer, even where the FCM merchant defaults.
    - ✓ Legally segregated operationally commingled (LSOC) – DCO can take margin of a non-defaulting customer if the FCM doesn't cover the default.
    - ✓ Legal segregation with recourse – DCO can take margin of a non-defaulting customer but only if all other sources of funds are insufficient.
    - ✓ Futures model – commingling of customer funds, so that one customer is at risk of another customer's default.

- LSOC model was adopted in the CFTC's Part 22 rule published in the Federal Register February 7, 2012. CFTC attempted to balance FCM concerns regarding cost against customer concerns about sufficient protection.
- Some futures market participants have pushed for better protection of futures margin.
  - ✓ MF Global highlights what can go wrong if margin isn't sufficiently segregated.
  - ✓ CFTC roundtable held February 29, 2012 and March 1, 2012 on protection of customer margin on futures trades.
    - ❑ Should LSOC or other models be adopted for futures transactions?
    - ❑ FCM insolvency.
    - ❑ FCMs also registered with the SEC as broker dealers.

- Uncleared Swaps
  - Insolvency analysis much like pre-Dodd Frank.
  - Segregation of Collateral.
    - ✓ Pre-Dodd Frank, growing trend to segregate collateral with third party custodians.
    - ✓ Dodd Frank requires a swap dealer or major swap participant to permit segregation of Independent Amount / initial margin with a third party custodian if customer requests.
      - ❑ Applies to Independent Amount / initial margin only.
      - ❑ Doesn’t account for daily market swings in value of transactions or value of collateral.
      - ❑ Doesn’t apply if neither party to the trade is a swap dealer or major swap participant. May be significant in certain sectors, such as energy, or if *de minimis* exception to swap dealer definition is large.
    - ✓ Collateral segregation arrangements in swaps trading relationships can be difficult to put in place.

- ✓ A rule proposed in December 2010 by the CFTC raises some of the difficult issues under collateral segregation. No final rule yet.
  - ❑ Who chooses the custodian?
  - ❑ Custodian’s fees.
  - ❑ Disclosure of fees/costs, difference in swap terms if collateral segregation is requested.
  - ❑ When must custodian transfer collateral; control and perfection of security interest.

- ➢ More protections in the system after Dodd Frank, more complex insolvency analysis. Are we better off?

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