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Ladies and Gentlemen

Developing effective resolution arrangements for investment banks

The International Swaps and Derivatives Association (**ISDA**)¹ is grateful for the opportunity to respond to the consultation document “Developing effective resolution arrangements for investment banks” (May 2009) (the **Consultation Document**). As you know, we followed closely the UK consultative process relating to the Banking Act 2009 and related secondary legislation, in particular, in relation to safeguards for netting, set-off, financial collateral and security arrangements and related matters.

The Banking Act 2009 is aimed primarily at UK banks and building societies but includes enabling provisions allowing the Treasury by order to make insolvency regulations in relation to investment banks. We understand that the inclusion of these enabling provisions in the Banking Act 2009 was inspired by the collapse of Lehman Brothers and the various difficulties that are perceived to have arisen during the course of the administration of the Lehman UK entities. We also understand that the Consultation Document is not limited to considering whether insolvency law reforms are necessary in relation to investment banks, but considers a number of other issues arising out of market difficulties raised by the Lehman case. We note that the purpose of the

¹ ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. ISDA currently has more than 800 member institutions from 56 countries on six continents. More than half of the total membership is based in the European Union and neighbouring countries and a significant portion of the rest active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

Consultation Document is to look forward and not to analyse in detail or criticize the conduct of the Lehman administration.

Paragraph 1.51 of the Consultation Document makes clear that the purpose of the Consultation Document is not to set out concrete policy recommendations. Instead it surveys issues raised by recent market events and identifies areas where further work and reform should be considered. The Treasury has been assisted in its work on investment bank issues by an Advisory Panel of industry practitioners, described in paragraph 1.32 of the Consultation Document.

The Consultation Document discusses a number of issues of great importance to our members, and we intend to follow closely the continuing consultative process on these issues and to comment, as appropriate, on more detailed proposals in due course. Our membership includes not only UK investment banks but also many other market participants, UK, European and from outside Europe, who are active in the London financial markets. We therefore bring an international perspective to bear on the issues you are considering. We have always recognised the importance of London to our membership as a regional and international financial centre, which is why we are following this UK consultative process (as we did in the case of the Banking Act 2009 and other UK financial market consultations in the past) with particular attention.

We do not propose in our response to answer the individual questions directly and in detail, as we believe that others are better placed to do that, in particular, the members of the Advisory Panel and various UK trade and professional bodies that we understand are responding separately to the Consultation Document. Instead, however, we would like to comment on various points raised by the Consultation Document in a more general way, from the perspective of international derivatives market participants, in the hope that you will find this helpful.

1. The Consultation Document focuses on three broad areas in relation to potential investment bank failures, namely, the development of a more effective resolution regime for investment banks, dealing with open positions at the time of an investment bank failure and return of client assets. We agree that these are the areas that require further work and detailed analysis. We comment on each of these areas below, but first make some general observations.
2. We applaud the open and collaborative process that the Treasury has initiated in relation to investment bank issues and support the work of the Advisory Panel and its sub-groups. We believe that this model has been shown to work well in relation to the Banking Act 2009, as evidenced, for example, by the recent successful resolution of certain gaps in the protection given by the Safeguards Order² made under the Banking Act, in relation to which the Treasury was assisted by the Banking Liaison Panel and a sub-group of the Banking Liaison Panel, on which ISDA was represented.
3. We endorse the balanced approach outlined by the Treasury in paragraph 1.26 of the Consultation Document, combining market practice, regulatory and, only if necessary,

² The Banking Act 2009 (Restriction of Partial Transfers) Order 2009 SI 2009 No. 322, as amended with effect from 9 July 2009 by The Banking Act 2009 (Restriction of Partial Transfers) (Amendment) Order 2009 SI 2009 No. 1826.

legislative steps. In particular we agree that legislative changes should be kept to a minimum, because we also agree that, in relation to many of the issues discussed in the Consultation Document, the primary difficulties do not arise as a result of legal uncertainty but as a result of other factors. We comment on this in relation to certain specific issues in more detail below.

4. We strongly endorse the view that freedom of contract and therefore flexibility for sophisticated counterparties should be preserved as far as possible if one of the principal stated goals of the consultation is achieved, namely, to ensure that the financial markets are, as far as possible, competitive and efficient.
5. We note that the Treasury is alive to the complexities introduced by the fact that investment banks typically operate in cross-border groups and engage in a considerable degree of cross-border trading. We welcome the Treasury's assurance that this is borne in mind and, in particular, that coordination with European and other international efforts to address similar issues will be given a high priority, and we urge the UK to take a full and proactive part in those discussions (as we do all other countries where our members are actively involved in trading activities).
6. We note the section in Part 1 of the Consultation Document headed "Challenging misconceptions about the UK regime". We agree with the observations made in paragraphs 1.17 to 1.22 of the Consultation Document and in Box 1.C.

A more effective resolution regime for investment banks

7. Chapter 4 of the Consultation Document is the part dealing primarily with the possibility of creating a special resolution regime, including new insolvency procedures, for investment banks. We are somewhat concerned at the proliferation of new insolvency procedures as a result of the Banking Act 2009 and now these proposals.³ At the same time, we appreciate that some fine-tuning may be helpful to overcome some of the issues raised by the Lehman case. We would urge, however, that for the sake of legal certainty and predictability changes to the winding up and administration regimes that currently would apply to a UK incorporated investment bank under the Insolvency Act 1986 be kept to the necessary minimum. We note that this is consistent with the current view of the Treasury as set out in paragraph 4.62 of the Consultation Document.
8. As acknowledged in paragraph 4.55 of the Consultation Document, it will be important to ensure that the interaction of any new regime for investment banks with any existing regimes is clear, particularly for financial institutions that conduct both commercial and investment banking activities.
9. We are not yet convinced that there is a compelling case for changes to the winding up regime that would apply to an investment bank. We believe, however, that some changes

³ We note that, even prior to the Banking Act 2009, there were already numerous special insolvency regimes in the UK, including, for example, special regimes for building societies, insurance companies, friendly societies, industrial & provident societies, limited and general partnerships, open-ended investment companies, water and sewage undertakers, licensed water suppliers, protected railway companies and air traffic services companies. This is, of course, acknowledged in paragraph 4.8 of the Consultation Document.

to the administration regime, primarily to facilitate prompt return of client assets are worth considering. We agree that equal treatment of domestic and foreign creditors, which is a longstanding principle of current UK insolvency regimes, is of fundamental importance and should continue to be respected. Any amendments to the existing regimes should protect close-out netting, set-off, title transfer financial collateral and security arrangements for the same reasons of credit and systemic risk reduction, market efficiency and legal certainty that motivated the Safeguards Order. The UK's European law obligations in this regard, of course, reinforce this policy imperative.

10. We note that a number of the proposals in chapter 4 of the Consultation Document do not necessarily involve legislative changes but can be implemented by (preferably) market action or by regulatory action, for example, in relation to firm-level failure management. We believe that these proposals are worthy of further study, but the cost of any such arrangements should be proportionate to the actual risk of failure of any individual investment bank, which should, of course, be relatively remote.
11. Any continuity of service obligations introduced in relation to investment bank resolution should be as narrow as possible and provide appropriate protections for the rights, including property rights, of parties required to continue providing such services. Similar issues arose, as noted by the Consultation Document, in relation to Part 3 of the Banking Act 2009. Some industry concerns in relation to the continuity obligations in Part 3 were not fully addressed by the Safeguards Order or the Code of Practice issued under the Banking Act 2009, and we would urge the Treasury to take these concerns into account if similar continuity obligations in relation to investment bank administration are introduced. We can provide more detail on these points when a more specific proposal is made by the Treasury, however we did note some of these concerns in our correspondence with the Treasury during the consultative process prior to the Banking Act 2009.⁴

Dealing with open positions at the time of investment bank failure

12. Chapter 2 of the Consultation Document discusses various issues highlighted by the Lehman case in relation to settlement of positions open at the time that Lehman collapsed. The Consultation Document discusses three types of open position, namely, open cash-equity trades there were effected either on-exchange or over-the counter (OTC) as well as open exchange-traded derivatives positions and open OTC derivatives positions.
13. There is a great deal of discussion of settlement of OTC trades in Chapter 2, but almost all of it is concerned with OTC cash-equity trades. Paragraph 2.62, the final paragraph of Chapter 2, deals briefly with OTC derivatives positions. We are concerned, however, that the distinction between OTC cash-equity trades and OTC derivatives positions in the discussion may not be entirely clear for many readers because of the frequent use of the

⁴ See, for example, paragraph 9(c) of our letter dated 9 January 2009 responding to the November 2008 consultation document "Special resolution regime: safeguards for partial property transfers". More extensive concerns were raised, we understand, on behalf of the structure financing sector, about the continuity of service provisions.

terms “OTC trade” and “OTC trading”, without clarifying that those terms relate almost exclusively to OTC cash-equity trades in the context in which they are used in Chapter 2.

14. Being clear as to this distinction is important because a number of the difficulties that are alleged to have arisen in relation to “OTC [cash-equity] trades” did not, as a general rule, arise in relation to OTC derivatives positions. For example, while lack of default rules was, perhaps, a problem for OTC cash-equity trades, as highlighted by paragraph 2.60 of the Consultation Document, the vast majority of OTC derivatives positions were governed by ISDA Master Agreements, with detailed default and close-out provisions.
15. In relation to open OTC derivatives positions, some practical issues arose in relation to close-outs effected under the 1992 ISDA Master Agreements, although in practice these were resolved without too much difficulty in practice. Moreover, these same practical issues largely did not arise under the 2002 ISDA Master Agreement. This is because the preparation and publication of the 2002 ISDA Master Agreement was a market response to practical difficulties experienced during financial crises of the 1990s (for example, the Russian moratorium, the Asian currency crisis and the near collapse of LTCM).
16. In light of the foregoing, ISDA members and other market participants who had not yet moved to general use of the 2002 ISDA Master Agreement have shown a renewed interest in doing so. In addition, many ISDA members have chosen to amend their existing 1992 ISDA Master Agreements to incorporate the Close-out Amount provision of the 2002 ISDA Master Agreement in place of the Market Quotation and/or Loss provision of the 1992 ISDA Master Agreement.
17. It is well known that in August 2008 a number of leading dealers signed a multilateral amendment agreement to amend their 1992 ISDA Master Agreement with each other to incorporate the Close-out Amount approach. Various Lehman entities were, fortunately, signatories to that agreement, and this considerably improved the efficiency of dealer close-outs against Lehman entities than would otherwise have been the case had the close-outs been effected under the 1992 ISDA Master Agreement provisions. As noted above, however, even in the latter case, the vast majority of positions open against Lehman entities were eventually valued and closed out without insuperable difficulties in practice.
18. The benefits of the Close-out Amount approach were not limited to dealers but enjoyed by any counterparty to Lehman that had used the 2002 ISDA Master Agreement. Other ISDA members asked ISDA to facilitate upgrading their existing 1992 ISDA Master Agreement in light of the Lehman experience, for which purpose ISDA launched the 2009 ISDA Close-out Amount Protocol.
19. In addition to close-out of positions against Lehman entities, Icelandic banks and so on, there was, of course, the need to settle credit derivative transactions where such entities were reference entities. It is widely acknowledged that the market infrastructure for these settlements established by ISDA’s Credit Event Protocols and related auction technology

functioned well, proving that market solutions can function effectively even in periods of extreme market stress.

20. Every period of financial difficulty teaches new lessons, and the OTC derivatives market will continue to study the lessons of the Lehman collapse, the Icelandic bank crisis and other events of the past couple of years. We are not aware, however, of any particular issues that would require legislative or regulatory action, as one of the outcomes of this current consultative process in relation to resolution arrangements for investment banks, in relation to settlement of OTC derivatives positions (other than as discussed in the following paragraph).
21. We strongly agree that resolution of the difficulties associated with OTC cash-equity trades is necessary. The same difficulties, of course, also affect settlement of certain OTC derivative transactions, namely, physically-settled OTC equity derivative transactions that have become due for settlement (for example, as the result of the exercise of an option or the occurrence of a settlement date under an equity forward transaction or physically-settled equity swap). These transactions are settled identically to OTC cash-equity trades (that is, OTC spot trades in equities) once the relevant settlement obligation has arisen.
22. We agree with paragraph 2.28 of the Consultation Document that the new guidance to CREST Rule 13 provided by Euroclear UK & Ireland does not provide a complete solution to the difficulties raised by the Lehman case, or to the related legal uncertainty, and we urge the Treasury and the Advisory Panel to consider these issues further, particularly in light of the work being done by a working group of the Financial Markets Law Committee, which is highlighted in paragraph 2.40 and Box 2.D of the Consultation Document.

Return of client assets

23. We agree that the long delays in returning client assets in the Lehman case has frustrated the legitimate expectations of clients of Lehman and some sort of solution to these difficulties is needed to prevent similar difficulties arising in the future where a custodian of client assets collapses. We also agree that these difficulties were primarily occasioned by practical concerns (deficiencies in record-keeping, liens of sub-custodians and so on) and not by legal uncertainty. In other words, regulatory and/or market action is most likely to be the best way of dealing with the client asset issues raised by the Lehman collapse.
24. This is not to say that all aspects of dealing with a trustee in a commercial context (a custodian of client assets being a form of trustee under English law) are satisfactory from a legal point of view. Various issues, for example, were highlighted in reports by the Trust Law Committee during the course of the 1990s, for example, the fact that a trustee's breach of trust can cut off its recourse to trust assets to satisfy obligations it has incurred to a counterparty even where that breach is unrelated to its contract with the

counterparty. As far as we are aware, however, none of the issues highlighted by the Trust Law Committee were at the root of the difficulties in the Lehman case.

25. We agree with the observations in paragraphs 3.21 to 3.23 of the Consultation Document that some market participants may not have sufficiently considered their prime brokerage arrangements with Lehman, and therefore were not fully aware of the risk that they were running in relation to assets that were transferred to Lehman under title transfer collateral arrangements (where no trust interest of the client was retained) or under security or custody arrangements permitting Lehman to use the client assets.⁵
26. It is also important to remember that assets transferred under a title transfer collateral arrangement are not, strictly speaking, client assets. They become assets of the transferee and should properly speaking be credited to a proprietary account of the transferee. The client's "asset" in such a situation is merely the contingent contractual obligation owed by the transferee to return fungible assets provided that the transferor has not defaulted under its own obligation which the transfer of assets was intended to collateralise.
27. In fact, we believe that some market participants have perhaps been a bit disingenuous, since the collapse of Lehman's, in claiming that their legitimate expectations were defeated in situations where they transferred assets to Lehman under a security or custody arrangement with a right of use or under a title transfer collateral arrangement, in either case incurring credit risk to Lehman as a result. The legal principles underlying the handling of client assets, as outlined in Chapter 3 of the Consultation Document, would have been well-known to any experienced legal practitioner practising in the investment banking sector. Professional market participants would be expected to be properly advised in relation to all aspects of their arrangements, including the legal aspects. It is more likely that such market participants underestimated the risk of Lehman's default than that their expectation as to the legal treatment of the assets they transferred was genuinely defeated.
28. We believe, therefore, that any response to the difficulties relating to return of client assets should focus on regulatory and/or market solutions. Moreover, for sophisticated parties arrangements permitting a right of use and title transfer arrangements should continue to be permitted without significant restriction. These arrangements have developed for important commercial reasons and the flexibility that they offer are crucial to market efficiency in the wholesale financial sector. We note that the Treasury acknowledges this in paragraph 3.76 of the Consultation Document.
29. We do not believe that there is any tenable case for a change to the legal regime relating to the right of use of client assets or to title transfer arrangements. We believe, however,

⁵ The right of use in relation to security or custody arrangements is sometimes referred to commercially as a right of "rehypothecation", a term that is also used in this sense in the Consultation Document. This is a misnomer, however, as the term "rehypothecation" strictly means repledging, which does not involve disposition of the full title to an asset to a third party. As that is normally what occurs when a right of use is exercised, the use of the term rehypothecation is potentially misleading and best avoided in favour of the neutral term "right of use" (which is, for example, the term used in the EC Directive on financial collateral arrangements and in the UK implementation of that Directive in the form of the Financial Collateral Arrangements (No. 2) Regulations 2003. It should also be understood that a title transfer collateral arrangement does not involve a "right of use" as transferee becomes the outright owner of the assets at the time of the initial transfer.

that parties active in this sector should ensure that they have a full understanding of the legal basis of such arrangements and the relative allocation of risks. Accordingly, some effort, primarily market-driven, to improve the education of market participants in this regard may be the most appropriate response.

30. We note that there are a couple of references in Chapter 3 of the Consultation Document to “complex liens or set-off arrangements”. Without being familiar with all of the arrangements, it is difficult to assess this comment, but it seems unlikely that the set-off arrangements were themselves complex.
31. We would urge extreme caution in weakening set-off rights under English law as suggested in paragraphs 3.69 to 3.71. There are other ways to address the protection of client assets, and tinkering with the legal regime for set-off carries a high risk of “substantial unforeseen consequences” which, in paragraph 3.90 of the Consultation Document, the Treasury indicates it is keen to avoid.

We would be pleased to discuss these issues with you further and, as noted above, we will study with interest any further proposals in relation to resolution of investment bank failures. In the meantime, please do not hesitate to contact either of the undersigned if you have any questions regarding the points raised above or desire any further information about the perspective of the cross-border financial market on these matters.

Yours faithfully

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