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Ladies and Gentlemen

Establishing resolution arrangements for investment banks

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to respond to HM Treasury's consultation document "Establishing resolution arrangements for investment banks" (December 2009) (the **Consultation Document**). As you know, we responded to the Treasury's earlier (May 2009) consultation on investment firm resolution issues, and we have participated and continue to participate in the on-going consultations conducted through your Investment Firm Advisory Panel and its working groups. We are grateful for the opportunity to represent the views of the privately negotiated (or over-the-counter (**OTC**)) derivatives industry in those discussions.

1. Scope of the Consultation Document and our response

The Consultation Document addresses a wide range of issues of interest to our members, particularly those carrying on business as investment firms established in the UK and those dealing with UK investment firms. As we are primarily concerned with the derivatives sector of the financial markets, we will focus in this response on the issues raised in chapter 7 of the Consultation Document that relate directly to the OTC

[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 840 member institutions from 58 countries on six continents. More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are 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.

derivatives market. We note, in fact, that some of the points raised in that chapter are specifically directed to ISDA for consideration, as discussed further below. After addressing the issues raised in chapter 7, we will briefly discuss some of the other issues raised in chapters 2 to 6 and 8 of the Consultation Document that are of particular importance to the derivatives market, for example, on the question of "rehypothecation" (right of use) of client assets.

We are aware that other UK, European and International trade associations will be commenting in some detail on the issues raised in chapters 2 to 6 of the Consultation Document, and in some cases we have had the benefit of reviewing those responses in draft. For example, we have had the opportunity to review a near final draft of the response of the Association for Financial Markets in Europe (**AFME**). There is a strong overlap between the membership of AFME and our membership, and their response will undoubtedly have the support of our members on the broader issues.

We have also reviewed a near final draft of the response of the Insolvency Law Committee of the City of London Law Society (the **CLLS Insolvency Law Committee**). Several of the law firms represented on the CLLS Insolvency Law Committee are also associate members of ISDA. We defer to the legal experts on that committee as to the detail of their response and believe that their core conclusions are supported by our broader membership.

Finally, we have seen the response dated 5 March 2010 of the European Repo Council of the International Capital Market Association (the **European Repo Council**) in relation to the repo market questions in chapter 7 of the Consultation Document, and we make further reference to it below.

2. Chapter 7 of the Consultation Document

Section 2(a)(iii) of the ISDA Master Agreement

Paragraphs 7.5 to 7.14 set out a balanced summary of the issues raised by the Lehmans case in relation to Section 2(a)(iii) of the ISDA Master Agreement. ISDA welcomes the acknowledgement of the purpose and importance of Section 2(a)(iii).

ISDA believes that recent events, as well as the recent decision of the High Court in *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* and the *Metavante* decision in the US Bankruptcy Court, justify a review by its members to ensure that:

(i) the protection Section 2(a)(iii) offers to non-defaulting parties is preserved;

(ii) potential drafting ambiguities in Section 2(a)(iii) highlighted by the *Marine Trade* case are addressed, if necessary, in order to clarify the intended effect of the provision (acknowledging, however, that market participants may have different views on the correct interpretation of Section 2(a)(iii) which may, in some cases, differ from the *obiter* view of the judge in *Marine Trade*); and

(iii) Section 2(a)(iii) operates in the manner intended, it being acknowledged, as noted in paragraph 7.9 of the Consultation Document, that it is not intended to operate as a 'walkaway clause'.

<u>Question 80</u>: ISDA strongly agrees that neither a regulatory nor a legislative solution is necessary or desirable if a suitable market solution is reached. ISDA is committed to working with its members to work out such a market solution, preserving the protective effect of Section 2(a)(iii), particularly at the time a default occurs and during its immediate aftermath, while addressing the issues highlighted by recent market events.

Close-out valuations and a resources centre for liquidators/administrators

Paragraph 7.15 and Box 7.B are a fair summary of the current position in relation to close-out valuations. The market has focused a great deal of attention on these issues in recent years, as reflected in the "Close-out Amount" definition of the 2002 ISDA Master Agreement.

Current difficulties faced by liquidators and administrators in assessing close-out claims are, in some cases, due to lack of sufficient expertise to assess those claims. The development of a resources centre along the lines suggested by the Treasury in paragraphs 7.16 to 7.23 of the Consultation Document could perhaps help to ameliorate those difficulties, although that would depend on the precise nature and content of the resources centre, the availability of appropriately qualified risk managers and so on. We are aware that some respondents to the Consultation Document, in particular, AFME, (i) are sceptical whether a resources centre could be maintained at negligible cost (as suggested in the Consultation Document), (ii) believe that it would be difficult to keep the resources centre up-to-date and therefore relevant and effective to address close-out valuation issues and (iii) question whether such an undertaking should be funded out of public resources.

It may be that the real problem is not lack of appropriate resources. (We understand, for example, that the Lehman administrators have a significant number of appropriately qualified staff available specifically for the purpose of evaluating counterparty claims relating to close-out of OTC derivatives and other financial market positions.) Differences may arise between close-out valuations determined by creditors and close-out valuations determined by administrators for the same positions due to differences in valuation models and techniques used on each side. This is inevitable given that different market participants develop and employ different valuation models and techniques. The freedom of market participants to do so is essential to competitive and efficient markets.

We would therefore question whether the difficulties described in the Consultation Document are attributable to a lack of appropriately skilled resource or instead to valuation difficulties arising, for example, in relation to: (i) structured rather than “flow” (standardised and relatively high volume) products; (ii) transactions considerably larger or smaller than the average size traded on the market for the relevant product type; (iii) products for which there is no active secondary market or for which the market is illiquid; and (iv) products for which the related underlying market is distressed. By its nature, the

OTC derivatives market includes products or transactions that are not standardised but are instead customised to meet specific requirements of particular counterparties, for whom no standardised product or transaction in the flow market is appropriate. The valuation of customised transactions will not always be straightforward, and there may be differing views as to how such valuations should be performed and the parameters used to determine such valuations; these will need to be addressed on a case-by-case basis.

It may be, however, that a market solution could be found to ease the difficulties of liquidators and administrators, for example, by standardising the form, content and manner of delivery of OTC derivative close-out claims, in order to make it easier for insolvency officials to assess the claims and therefore to streamline the admission of the claims. It is clear, though, that there is unlikely to be a "one-size-fits-all" solution. The Treasury could encourage market discussions in this area.

It seems unlikely that a regulatory or legislative solution to this specific issue would be feasible, much less necessary or desirable.

Finally, we note in passing that the second sentence of paragraph 2.23 of the Consultation Document refers to the possibility of including provisions in the special administrative regime for financial disincentives if counterparties have provided unreasonable close-out valuations on derivatives transactions to administrators. We believe that this sentence relates to an idea discussed by the Treasury with the Investment Firm Advisory Panel, but which ultimately did not result in a formal proposal in chapter 7. In our view, the idea is not practicable, would be impossible to enforce and would, in any event, not address the close-out valuation issues raised in chapter 7.

<u>Question 81</u>: ISDA believes that the proposal of a resources centre to aid administrators may be worthy of further study, but there are serious objections to the proposal that must be considered. Also, the resources centre would not address the difficulties of reconciling OTC derivatives close-out valuations that have arisen even when (as in the case of the Lehmans administration) there are substantial expert resources available to the liquidators/administrators. An alternative approach to resolving these difficulties may be for the market to consider greater standardisation of the form, content and manner of delivery of OTC derivative close-out claims, in order to make it easier for insolvency officials to assess the claims and therefore to streamline the admission of the claims.

Repo market close-outs

The repo market referred to in the Consultation Document (understood broadly to include the securities lending market), as discussed in paragraphs 7.24 to 7.27 of the Consultation Document, is closely aligned with the OTC derivatives market, and our members are actively involved in it. The repo market as such is not, however, part of ISDA's area of direct focus as a trade association, and so ISDA defers to and supports the views of the European Repo Council and of AFME, each of which is more directly concerned with that market.

<u>Question 82</u>: See above.

Mitigating negative externalities

The issues raised in paragraphs 7.28 and 7.29 of the Consultation Document bring together a number of themes arising in other chapters of the Consultation Document. ISDA has no specific comments in relation to these points, but touches below on some of the themes to which paragraphs 7.28 and 7.29 make reference.

Questions 83 and 84: See above.

3. Chapters 2 to 6

As noted above, as a general matter, the issues raised in chapters 2 to 6 are not specifically derivatives market, although the issues are, of course, important to the derivatives businesses of investment firms and those who deal with them, as they are to other areas of investment firm business. We are aware that you will be receiving detailed submissions on the issues in chapters 2 to 6 from other trade and professional bodies, such as AFME and the CLLS Insolvency Law Committee. We therefore make only a few select observations on points that are closer to our core concerns:

- We are aware that there are differences of view among our members as to whether the case has yet been made out for a special administration regime, special administration objectives or modified liability standards for administrators. The issues and ideas discussed in chapter two of the Consultation Document are certainly worthy, however, of further study.

- We do agree that it is important to determine how a special administration regime for investment firms would work with the special resolution regime of the Banking Act 2009 in relation to any investment firm that was also authorised to accept deposits, and we welcome the Treasury's consideration of this question.

- We do not express a view on whether there should be special regime for post-administration financing (acknowledging, as noted in the Consultation Document, that comparable issues were recently canvassed by the Insolvency Service in relation to corporate insolvencies), but any such special regime should, of course, not interfere with netting, set-off, security or title transfer collateral arrangements or any property subject to a security arrangement.

- We broadly support the proposals in chapter 3 of the Consultation Document, but agree that considerably more work needs to be done on the detail. Any legislative or regulatory proposals to implement these ideas, of course, need to be proportionate and cost-effective.

- We believe that many of the issues discussed in chapter 4 of the Consultation Document may be dealt with by appropriate market action and that the Investment Firm Advisory Panel and its client asset working group could usefully focus on encouraging and providing guidance for such market action. We certainly favour clarity, increased transparency and improved speed of return of client assets. We question whether mandated product warnings in contractual agreements between professionals is necessary. We favour clarity in contractual arrangements, but this should be market-led. Market documentation is regularly stress-tested by events and while stability in standard terms is also important, each new crisis has tended to result in improvements to standard form documents. The 2002 ISDA Master Agreement, for example, reflects the experience of ISDA members of various market events and crises, particularly in the late 1990s, including the Russian moratorium, the near collapse of LTCM and the Asian currency crisis. We are confident that the market has the ability to learn and apply the lessons of the past couple of years to its standard form documents, in the OTC derivatives sector, in the repo and securities lending sectors and in other sectors of the financial markets.

- We welcome the Treasury's acknowledgement in paragraphs 4.19 to 4.23 of the Consultation Document that so-called "rehypothecation" (right of use) of client assets (or more generally assets provided as collateral by a counterparty, who may not be a client in the regulatory sense) can serve an important commercial purpose and that parties should have the freedom to structure their arrangements accordingly. We also agree with the Treasury's view that the legal concepts and rules underpinning the different arrangements outlined, for example, in Table 4.B are relatively clear, even if some counterparties of Lehmans seem either to have been unaware of the credit risk consequences of rehypothecation (or, less charitably, to have taken the credit risk willingly or neglectfully, only to cry "foul!" after the Lehmans collapse). Again, as noted above, where such counterparties are hedge funds or other professional firms, we are sceptical of the need for (and, indeed, oppose in principle) mandated product warnings in contracts between investment firms and professional counterparties.

- In relation to paragraphs 4.24 to 4.28 and related Question 35, we would urge the Treasury to ensure that any UK legislation in relation to shortfalls in client omnibus accounts takes account of the Geneva Securities Convention, to which the Treasury makes reference in Chapter 8, as well as to any European work implementing the recommendations of the European Commission's Legal Certainty Group, which we understand is currently being carried forward in relation to a proposed European securities Directive. This would, we believe, result in a loss allocation rule broadly in line with the recommendation of the Financial Markets Law Committee (**FMLC**) made in its July 2004 report "Property interests in investment securities", to which the Consultation Document makes reference in a footnote to paragraph 4.26.

- We believe that the Treasury is not proposing any change to the legal regime underlying rights of set-off and liens, but clarification of custody arrangements and perhaps changes to related contractual arrangements in order to simplify the analysis of client asset holdings. In answer to Question 46 of the Consultation Document, we think that it should be clear in principle that a custodian should not exercise a right of set-off or enforce a lien against assets belonging to a client to satisfy liabilities owed in a principal capacity by the investment firm dealing with that client. We favour segregation of client assets from house assets of a firm to simplify the process of identifying client assets and facilitate their return. We appreciate that there is a potentially difficult international aspect to this where a UK investment firm uses a custodian in a jurisdiction without appropriate safeguards for client assets. This underlines the importance of the international dimension discussed in chapter 8 of the Consultation Document.

- We believe that detailed and, as far as possible, market-led work on custody and segregation issues could go a long way toward reducing or even eliminating the need for additional special rules or regulatory requirements to facilitate return of client assets, although we acknowledge that some changes to client money and client asset rules and regulatory requirements are likely and desirable to strengthen the existing regime, particularly in light of the December 2009 judgment of Mr Justice Briggs in *Re Lehman Brothers International (Europe) [Client Money]* and, of course, subject to the outcome of the appeal of that judgment.

- Along the same lines, we believe that strengthening the current client money and client asset regime along existing lines, with improved clarity of custody arrangements and related contracts, could obviate the need for the establishment of a client assets trustee (CAT) or a client assets agency (CAA), as discussed in chapter 5 of the Consultation Document. In the meantime, the Investment Firm Advisory Panel should encourage market-led solutions such as the development of bankruptcy-remote third party custodians to hold client assets, as discussed in chapter 5 of the Consultation Document.

- While chapter 6 does not strictly speaking deal with derivatives issues, legal certainty for settlement of equity trades is clearly important for the equity derivatives market, which is closely related to and interdependent with the cash equities trading market. In principle, we support the AFME Protocol for cash equity trades, which we understand is still in development, while agreeing with the FMLC that additional regulatory measures may be needed, as noted in paragraph 6.34 of the Consultation Document, which refers in a footnote to the FMLC paper "Issue 140 – Unsettled OTC Trades" (September 2009). The discussion in paragraphs 6.11 to 6.39 deals with the contractual aspect of unsettled cash equity trades, while paragraphs 6.68 to 6.80 deal with the settlement aspects and specifically the CREST system rules as operated by Euroclear UK and Ireland (**EUI**). These need to be considered together as two aspects of the same problem of unsettled OTC cash equity trades, as discussed in the FMLC paper.

- We also note the importance of the clearing issues discussed in paragraphs 6.40 to 6.67 of the Consultation Document. A great deal of market-led work is currently being done on these issues, and we recommend that, as far as possible, such market work should be carefully considered by the Treasury and the Investment Firm Advisory Panel before deciding whether any further legal or regulatory initiative in this area is necessary. We believe that paragraphs 6.40 to 6.67 set out a useful summary of current issues and areas of focus in relation to clearing.

- Not surprisingly, in relation to the issues raised in paragraphs 6.81 to 6.88 of the Consultation Document in respect of contractual arrangements between investment managers and investment firms, we favour market action and do not believe that the case has yet been made out for UK government action in relation to such contractual arrangements.

4. Chapter 8

We strongly endorse the Treasury's recognition of the importance of international cooperation in relation to cross-border resolution, and we commend the proactive role that the United Kingdom has played in those discussions. In recent months, ISDA has responded to the Basel Committee on Banking Supervision Cross-Border Resolution Group Report and Recommendations and to the European Commission's Communication on Cross-Border Crisis Management in the Banking Sector.[2]

ISDA has for many years focused an important part of its law reform efforts on international initiatives to promote legal certainty in relation to key issues facing the financial markets. ISDA has therefore actively participated in law reform initiatives of the Hague Conference on Private International Law, UNCITRAL and UNIDROIT as well as European and other regional law reform initiatives (as well as in national law reform initiatives, over the years, in dozens of countries around the world). The broader context of financial law reform represented by these other initiatives should not be neglected in the focus on cross-border resolution. Legal certainty is always important for the financial markets, but particularly during times of market stress.

We note that while mention is made in chapter 8 of the Consultation Document of several international bodies, including UNCITRAL and UNIDROIT, no mention is made of the Hague Conference on Private International Law. We would, however, underline the threshold importance of there being legal certainty as to private international law rules governing or otherwise affecting financial transactions, and in this regard would once again urge the United Kingdom to do what it can to bring the Hague Securities Convention (which provides the private international law counterpart to the substantive law principles for intermediated securities laid out in the Geneva Securities Convention, outlined in Box 8.D of the Consultation Document).

We strongly endorse the Treasury's recognition, in paragraphs 8.20 to 8.24 of the Consultation Document, of the importance of cross-border cooperation. In particular, we welcome the Treasury's highlighting, in paragraph 8.24, of the importance of mutual recognition of statutory transfers under resolution regimes of "foreign property" (that is, rights, liabilities and other property of a failed firm that is subject to a law other than the law governing the resolution of that firm).

One of the issues highlighted during the consultation process that preceded the Banking Act 2009 was the issue of foreign property and specifically whether a foreign court would recognise a transfer by the Treasury or the Bank of England, exercising a partial property transfer power under the Banking Act 2009, of a right, liability or other property subject that foreign court's own law. Of course, mutual recognition should only be accorded where the relevant resolution regime provides appropriate protections for creditors and other parties affected by a statutory transfer, either by way of an appropriate safe harbour

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[2] Copies of each response are available from ISDA's website at http://www.isda.org.

(for example, in relation to netting, set-off, security or title transfer collateral) or by ensuring adequate compensation. These are not necessarily easy issues, but we endorse the Treasury's view that international initiatives to achieve an appropriate mutual recognition regime should be supported.

We would be pleased to meet with you to continue our discussions with you regarding the issues arising out of the Consultation Document. We look forward to participating in further discussions of the Investment Firm Advisory Panel and its working group on creditor and counterparty issues. We would also be happy, as in the past, to meet with you bilaterally to discuss issues relevant to the OTC derivatives market. In the meantime, please do not hesitate to contact either of the undersigned if we can be of assistance in relation to these issues.

Yours faithfully

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