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MEMORANDUM OF LAW

prepared for

LCH LIMITED

in respect of

**the validity and enforceability of the clearing documentation of LCH Limited
under the federal laws of the United States and the laws of the State of New York**

April 15, 2020

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1. INTRODUCTION

We have been asked, as special United States counsel to LCH Limited (“**LCH**”), to prepare this memorandum of law (“**Memorandum**”) to address the questions presented in Section 5 below pursuant to the laws of the State of New York and certain of the federal laws of the United States of America (together, the “**Relevant Jurisdiction**”).

In preparing this Memorandum:

- (a) we have only reviewed the documents listed in Section 2 below; and
- (b) we have relied on the assumptions set out in Section 3 below.

In addition, this Memorandum is subject to the limitations and qualifications set out in Section 4 below.

2. LCH AGREEMENTS

In preparing the Memorandum, we have reviewed the following documents (together, the “**LCH Agreements**”) relating to LCH’s RepoClear Clearing Service, SwapClear Clearing Service, ForexClear Clearing Service and Listed Interest Rates Clearing Service (together, the “**Relevant Clearing Services**”):

- (a) LCH’s General Regulations dated April 14, 2020 and Procedures (“**Rulebook**”);
- (b) LCH’s FCM Regulations dated March 5, 2020 and FCM Procedures dated March 24, 2020 (together, the “**FCM Rulebook**”);
- (c) LCH’s Default Rules dated March 26, 2020 (“**Default Rules**”);
- (d) LCH’s Settlement Finality Regulations dated October 12, 2019 (the “**Settlement Finality Regulations**”);
- (e) LCH’s template Clearing Membership Agreement (“**CM Agreement**”);
- (f) LCH’s template Deed of Charge (“**Deed of Charge**”); and
- (g) LCH’s template Security Deed (“**Security Deed**”).

Capitalized terms not otherwise defined herein have the meanings ascribed to them in the LCH Agreements.

3. ASSUMPTIONS

In preparing this Memorandum we have made the following assumptions:

- (a) LCH is a private company limited by shares incorporated under the laws of England and Wales and with its registered office and primary place of business in London;

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- (b) each of LCH's clearing members addressed in this Memorandum (a "**Relevant Clearing Member**") is located in the United States and is:
 - (i) registered with the U.S. Commodity Futures Trading Commission ("**CFTC**") as a futures commission merchant ("**FCM**") (each, an "**FCM Clearing Member**"); or
 - (ii) registered with the U.S. Securities and Exchange Commission ("**SEC**") as a broker-dealer (each, a "**BD Clearing Member**"); or
 - (iii) regulated as a bank by a U.S. federal or state banking regulator (each, a "**Bank Clearing Member**"); or
 - (iv) registered with the CFTC as a swap dealer but is not regulated as a bank by a U.S. federal or state banking regulator (each, a "**Non-Bank SD Clearing Member**").
- (c) no FCM Clearing Member provides clearing services to an affiliate within the meaning of CFTC Rule 1.3;
- (d) LCH and each Relevant Clearing Member has the capacity, power and authority, under all applicable laws, to enter into and to exercise its rights and to perform its obligations under the LCH Agreements and each Contract (or, in the case of an FCM Clearing Member, an FCM Contract) (together, the "**Relevant Contracts**") and has duly authorized, executed and delivered the LCH Agreements and each such Relevant Contract;
- (e) the LCH Agreements and all Relevant Contracts are legal, valid, binding and enforceable in accordance with their respective terms and conditions under the law that governs them;
- (f) LCH and the Relevant Clearing Members have entered into each Relevant Contract for *bona fide* commercial purposes and on an arm's-length basis;
- (g) LCH is at all relevant times solvent and not subject to insolvency, reorganization or similar proceedings under the laws of any jurisdiction;
- (h) there are no other agreements, instruments or arrangements between LCH and any Relevant Clearing Member which conflict with, modify or supersede the LCH Agreements;
- (i) the obligations assumed between LCH and each Relevant Clearing Member under the LCH Agreements are mutual;
- (j) LCH and each Relevant Clearing Member will perform their obligations under the LCH Agreements in accordance with their respective terms;
- (k) the requirements of the applicable laws governing the transfer of cash and securities are complied with;
- (l) this Memorandum is only given as of the date of the LCH Agreements in effect as of the date of this Memorandum;

- (m) except as otherwise discussed herein, in the event of a default of a Relevant Clearing Member, the return of customer funds and assets to the estate of the insolvent Relevant Clearing Member is not impeded pursuant to the laws and/or regulations of the jurisdiction where such funds and assets may be held;
- (n) this Memorandum is limited to matters arising under the New York state and U.S. federal commodity and bankruptcy laws expressly referred to herein;
- (o) LCH and the Relevant Clearing Members are in compliance with applicable laws of their respective jurisdictions at all relevant times, including in respect of any applicable licensing, registration and authorization requirements necessary for entering into and performing their respective obligations under the LCH Agreements and the Relevant Contracts; and
- (p) no revisions to the LCH Agreements will contradict or change any of the assumptions set out above.

4. LIMITATIONS AND QUALIFICATIONS

This Memorandum is limited to the laws of the State of New York and the federal laws of the United States of America expressly referred to herein and does not purport to address the law of any other jurisdiction, including English law or the laws of the European Union. This Memorandum is given as of the date hereof and we assume no obligation to update the discussion contained herein subsequent to this date.

5. ANALYSIS

5.1 General

5.1.1 Are there any statutory limitations on the capacity of, or specific regulatory requirements associated with, any Relevant Clearing Member entering into the LCH Agreements (including for the purpose of granting of security under the Deed of Charge)?

In the United States, there are separate statutory and regulatory frameworks applicable to different classes of financial products. “Commodity interests” are regulated by the CFTC under the U.S. Commodity Exchange Act (“CEA”). By contrast, “securities” are regulated by the SEC under the U.S. federal securities laws, including the U.S. Securities Exchange Act of 1934, as amended (“Exchange Act”). A bank is generally subject to regulation under the Exchange Act and the CEA in connection with its securities and commodity interest activities, respectively, however certain exemptions from registration obligations under the Exchange Act may be available in connection with a bank’s securities activities.

Commodity Interests (SwapClear, ForexClear, Listed Rates)

The CEA and the CFTC Rules govern trading in “commodity interests” – a term which includes, *inter alia*, swaps and futures contracts¹ – by persons located in the United States. The products accepted for clearing as part of the SwapClear and ForexClear Services, which include interest rate swaps, non-deliverable foreign exchange forwards, foreign exchange swaps, and foreign exchange options – all qualify as “swaps” as defined in the CEA.² Any futures contracts listed for trading on a U.S. designated contract market (each, a “**DCM**”, and such futures contracts, “**DCM Futures**”) clearly fall within the definition of “commodity interest”.³ In addition, the listed interest rate futures accepted for clearing as part of the Listed Rates Clearing Service qualify as Foreign Futures. Therefore any Relevant Clearing Member that clears swaps, DCM Futures or Foreign Futures as a member of LCH’s SwapClear, ForexClear and/or Listed Rates Services may only do so in accordance with applicable provisions of the CEA and the CFTC Rules.

Principally, Section 4d(f) of the CEA and CFTC Rule 30.4(a) provide that, absent an applicable exemption, it is unlawful for any person to solicit or accept orders for or involving swaps or Foreign Futures, respectively, and, in connection therewith, to accept any money, securities or property (or extend credit in lieu thereof) to margin, guarantee or secure any trades or contracts that result or may result therefrom, unless such person shall have registered with the CFTC as an FCM and such registration has neither expired nor been suspended nor revoked. Therefore, a Relevant Clearing Member that provides clearing services to customers in relation to the SwapClear Clearing Service, ForexClear Clearing Service or the Listed Rates Clearing Service will be required to register as an FCM, absent an applicable exemption.⁴

¹ See CFTC Rule 1.3 (defining “commodity interest” to include, *inter alia*, “any contract for the purchase or sale of a commodity for future delivery” (*i.e.*, a futures contract) as well as “any swap as defined in the [CEA]”). The CFTC also has the authority to regulate the offer and sale of futures contracts traded on, or subject to the rules of, a foreign (*i.e.*, non-U.S.) board of trade (“**FBOT**”) by or to persons located in the United States (such futures contracts, “**Foreign Futures**”).

² See Section 1a(47)(A)(iii) of the CEA (defining a “swap” to mean, *inter alia*, “any agreement, contract, or transaction . . . that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more . . . indices, . . . or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as . . . an interest rate swap . . . a foreign exchange swap . . . that is an agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap . . . [or] that is any . . . option on, [such] agreement, contract, or transaction”). CFTC Rule 1.3 (definition of “swap”) expressly includes cross-currency swaps, foreign exchange options, foreign exchange forwards, non-deliverable foreign exchange forwards, foreign exchange swaps and forward rate agreements within the term “swap”. Although not relevant to the analysis herein, we note that certain physically-delivered foreign exchange swaps and forwards are excluded from the definition of “swap”. See Section 1a(47)(E)(i) of the CEA.

³ Subject to several narrow exceptions, the CEA prohibits any person from offering to enter into, entering into, executing, or confirming the execution of futures contracts in the United States unless such transaction is conducted on, or subject to the rules of, a DCM. See Section 4(a) of the CEA.

⁴ A Relevant Clearing Member that only clears for “proprietary accounts” – which is defined in CFTC Rule 1.3 to include, *inter alia*, the accounts of affiliates as well as house accounts – is not required to register with the CFTC. See CFTC Rule 3.10(c)(1). CFTC Rule 30.4(a) also provides an exemption from FCM registration requirements to any non-U.S. broker that accepts orders from, or carries: (i) an FCM’s customer omnibus account, as that term is defined in CFTC Rule 30.1(d); (ii) an FCM’s proprietary account, as that term is defined in CFTC Rule 1.3; or (iii) the account of a U.S. affiliate that is proprietary to the non-U.S. broker, as the term “proprietary account” is defined in CFTC Rule 1.3.

An applicant for FCM registration must submit, and must ensure that each of its associated persons (each, an “FCM AP”)⁵ submits, a completed registration application to the National Futures Association (“NFA”).⁶ Once registered, FCMs and FCM APs must become NFA members and must comply with an extensive set of compliance requirements under the CEA, CFTC Rules and the NFA rulebook. Most importantly, registered FCMs are subject to special customer funds protection requirements in respect of cleared swaps and Foreign Futures.⁷

Even though a Relevant Clearing Member that clears solely for its own account does not fall within the definition of an FCM it may, depending on the nature and extent of its swap trading activities, be required to be registered as a swap dealer.⁸ Very generally, a Relevant Clearing Member will be subject to swap dealer registration requirements where it engages in swap dealing activity in excess of a *de minimis* threshold of \$8 billion in total gross notional dealing swaps with all counterparties over a rolling 12-month period, or \$25 million in total gross notional dealing swaps with so-called “Special Entity” counterparties over a rolling 12-month period.⁹ An applicant for swap dealer registration must submit a completed registration application to NFA and, once registered, must become an NFA member. However, a swap dealer is not required to register its associated persons with NFA, nor are such associated persons currently subject to any examination requirements.¹⁰ An applicant for swap dealer registration must, however, determine whether any of its associated persons is subject to a statutory disqualification under the CEA.¹¹ Once registered, a swap dealer is subject to a wide range of ongoing compliance obligations relating to its internal and external business conduct standards, its capital requirements, and additional rules relating to margining of uncleared swaps.¹²

Accordingly, a Relevant Clearing Member that participates in the SwapClear Clearing Service or the ForexClear Clearing Service and clears solely for its own house accounts may be subject to swap dealer registration requirements, unless it is able to rely on the *de minimis* exemption.

⁵ CFTC Rule 1.3 defines an “associated person” of an FCM as any natural person that is “a partner, officer, or employee (or any natural person occupying a similar status or performing similar functions), in any capacity which involves: (i) the solicitation or acceptance of customers’ orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged”.

⁶ The application for FCM registration must be submitted on a completed Form 7-R whereas each “principal” and applicant for FCM AP registration must submit a completed Form 8-R.

⁷ See CFTC Rules 22.2 and 30.7.

⁸ See Section 4s(a)(1) of the CEA (“It shall be unlawful for any person to act as a swap dealer unless the person is registered as a swap dealer with the [CFTC]”).

⁹ See CFTC Rule 1.3 (setting out the *de minimis* exception from swap dealer registration). See also CFTC Rule 23.401(c) (defining “Special Entity” to include, *inter alia*, U.S. federal and state agencies, endowments and certain government and employee benefit plans). In late 2018, the CFTC amended CFTC Rule 1.3 to make permanent the \$8 billion and \$25 million thresholds. See *De Minimis Exception to the Swap Dealer Definition*, 83 Fed. Reg. 56666 (November 13, 2018).

¹⁰ Associated persons of swap dealers will be required to complete the NFA’s swaps proficiency requirements by January 31, 2021. See National Futures Association: Proposed Amendments to NFA Bylaw 301 and NFA Compliance Rule 2-24 and Proposed Interpretive Notice Entitled: *NFA Bylaw 301 and Compliance Rule 2-24: Proficiency Requirements for Swap APs* (March 5, 2019).

¹¹ The swap dealer must also supervise all of its associated persons. See CFTC Rule 3.12(f)(5)(ii).

¹² See generally Part 23 of the CFTC Rules.

Securities (RepoClear)

The Exchange Act and related SEC Rules govern the trading of securities by U.S. persons. Through the RepoClear Service, LCH accepts for clearing RepoClear Repo Transactions and RepoClear Bond Transactions.¹³ The SEC has historically taken the view that a repo constitutes a purchase and sale of the securities underlying the repurchase agreement, hence the RepoClear Repo Transactions (and, following acceptance for clearing, the resulting RepoClear Contracts) are properly characterized as transactions in “securities” for purposes of the Exchange Act.¹⁴ In addition, bonds fall clearly within the Exchange Act definition of “security”.¹⁵ Therefore, any Relevant Clearing Member may only participate in the RepoClear Service in accordance with the provisions of the Exchange Act and related SEC Rules.

In particular, the Exchange Act provides for the regulation of “brokers” and “dealers” that engage in securities trading activities.

A “broker” is defined as “any person engaged in the business of effecting transactions in securities for the account of others” and must register as such under the Exchange Act, absent an applicable exemption.¹⁶ Accordingly, unless an exemption is available, any Relevant Clearing Member that provides customer clearing services in securities must register with the SEC as a broker.¹⁷ A Relevant Clearing Member that is a bank may be exempt from otherwise-applicable broker registration requirement to the extent it qualifies for the bank “trustee” exemption described in more detail below.

A “dealer” is defined as “any person engaged in the business of buying and selling securities...for such person’s own account through a broker or otherwise”.¹⁸ Expressly excluded from this

¹³ Defined in the Rulebook as RepoClear Transactions entered into for the trade of a repo and for the trade of one or more bonds, respectively.

¹⁴ See, e.g., Brief for the Securities and Exchange Commission, Amicus Curiae, Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13 (2d. Cir. 1986), cert. denied, 107 S. Ct. 952 (1987). See also SEC Division of Trading and Markets, “Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules” (November 11, 2007) (stating that “repurchase agreement transactions are treated as purchases and sales of securities for [U.S. federal] securities law purposes”), available at: <http://www.sec.gov/divisions/marketreg/bankdealerguide.htm>.

¹⁵ See Section 3a(10) of the Exchange Act (“the term ‘security’ means any note, stock, treasury stock, security future, security-based swap, *bond*, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a ‘security’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited”) (emphasis added).

¹⁶ See Section 3a(4) of the Exchange Act.

¹⁷ The SEC staff has historically found that holding oneself out as providing brokerage services or facilitating the settlement of securities transactions constitutes being “engaged in the business of” a broker. See, e.g., SEC Staff Letter, BondGlobe, Inc. (February 6, 2011).

¹⁸ See Section 3a(5) of the Exchange Act. Factors indicating that a person may be a “dealer” include: issuing or originating securities; having a regular clientele; holding oneself out as buying or selling securities on a regular basis; maintaining a securities inventory; acting as a market maker; and buying and selling securities as a principal. Dealer registration is also generally required

definition is a “trader”, *i.e.*, any person that “buys or sells securities for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business”.¹⁹ A Relevant Clearing Member clearing for its own account may therefore be required to register as a dealer to the extent it cannot qualify as a “trader”. A Relevant Clearing Member that submits RepoClear Repo Transactions for registration is less likely to qualify for the “trader” exemption from dealer registration.²⁰

Where a Relevant Clearing Member’s participation in the RepoClear Service requires registration as a broker and/or a dealer, and no exemptions are available, the Relevant Clearing Member must register with the SEC and become a member of FINRA.²¹ Registration and membership are considered as part of a consolidated application package.²² An applicant must also ensure that each of its associated persons that will act as either a principal or a registered representative (each, a “**BD AP**”) submits a completed registration application and meets applicable examination requirements.²³ Once registered, BDs and their BD APs must comply with an extensive set of compliance requirements under the Exchange Act, SEC Rules and the FINRA Rules, including antifraud, financial integrity and customer protection provisions.

Banks

The United States has a “dual” banking system of national and state banks.²⁴ While the details of U.S. federal and state banking regulations are beyond the scope of this Memorandum, we note that banks benefit from certain narrow exemptions from BD registration in connection with offering securities brokerage services to their customers. In particular, Relevant Clearing Members that are banks may offer clearing services in respect of securities as a “trustee” without needing to register as a broker.²⁵

where a person runs a book of repurchase and reverse repurchase agreements. *See, e.g.*, SEC Staff Letter, Louis-Dreyfus Corp. (July 23, 1987); SEC Staff Letter, Acqua Wellington North American Equities Fund, Ltd. (July 11, 2001).

¹⁹ The factors indicating that a person may be a “trader” are generally the converse of the factors indicating “dealer” status, *e.g.*, not issuing or originating securities; not holding oneself out as buying and selling securities on a regular basis; and not acting as market maker.

²⁰ As identified in note 18, *supra*, the SEC has historically found dealer registration to be required where a person runs a book of repurchase and reverse repurchase agreements.

²¹ A registered BD must also become a member of the Securities Investor Protection Corporation (“**SIPC**”).

²² The application for broker-dealer registration (“**Form BD**”) must be submitted through FINRA’s online Central Registration Depository (“**WebCRD**”) whereas the application for FINRA membership (“**Form NMA**”) and related documentation, including business plan, written supervisory procedures, clearing and other service provider agreements, financial records, and policy documentation, must be submitted through FINRA’s Electronic Filing System (“**EFS**”).

²³ Registration applications must be submitted through WebCRD on Form U-4.

²⁴ For example, a bank could be chartered under the U.S. National Bank Act as a “national association” subject to regulation by the U.S. Office of the Comptroller of the Currency or could be a state-chartered bank regulated by the relevant state banking authority. State-chartered banks that are members of the Federal Reserve System are subject to prudential regulation by the U.S. Federal Reserve.

²⁵ *See* Section 3a(4)(B)(ii) of the Exchange Act (bank “trustee” exemption from definition of “broker”). A bank is also excluded from the definition of “broker” to the extent that it effects fewer than 500 non-excluded securities transactions in any calendar year. *See* Section 3a(4)(B)(xi) of the Exchange Act.

To qualify, a bank must effect securities transactions in a trustee or fiduciary capacity through its trust department and must be “chiefly compensated” through either an annual fee, a percentage of assets under management or a flat/capped fee per order not to exceed the bank’s transaction costs. A bank also may not publicly solicit brokerage business other than through its trust activities. The SEC has promulgated Regulation R under the Exchange Act which clarifies, *inter alia*, the method of calculating the “chiefly compensated” test and relevant advertising restrictions.²⁶

5.1.2 Would LCH be deemed to be domiciled, resident or carrying on business in the Relevant Jurisdiction by virtue of providing clearing services to a Relevant Clearing Member? If so, would LCH be required to obtain a license or be registered before providing clearing services to a Relevant Clearing Member or are there any special local arrangements for the recognition of overseas clearing houses in these circumstances?

The application of registration requirements to LCH will depend on whether LCH is providing clearing services to Relevant Clearing Members in respect of commodity interests or securities.

Commodity Interests

Section 5b(a) of the CEA makes it unlawful for any “derivatives clearing organization” (“**DCO**”)²⁷ to make use of any means of instrumentality of interstate commerce in its operations with respect to swaps and futures contracts unless registered with the CFTC.²⁸ Accordingly, the provision of the SwapClear and ForexClear Clearing Services to Relevant Clearing Members – which necessarily implicates the use of U.S. jurisdictional means – would trigger DCO registration requirements for LCH. Similarly, only a CFTC-registered DCO is permitted to provide clearing services in respect of DCM Futures.²⁹ In this regard, we note that LCH is properly registered as a DCO with the CFTC, and is permitted by its order of registration to provide clearing services to U.S. persons in respect of swaps and DCM Futures.³⁰

²⁶ See Rules 721-723 under Regulation R, 247 CFR 721-723.

²⁷ Section 1a(15) of the CEA defines a “derivatives clearing organisation” generally as a “clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the [DCO] for the credit of the parties; (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the [DCO]; or (iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the [DCO] the credit risk arising from such agreements, contracts, or transactions executed by the participants”. The term is therefore not restricted only to those persons registered as a DCO with the CFTC. The definition expressly excludes non-central counterparty settlement systems, interbank payment systems and settlement of spot transactions.

²⁸ Section 5b(a) of the CEA states: “Except as provided in paragraph (2), it shall be unlawful for a [DCO], directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a [DCO] with respect to (A) a contract of sale of a commodity for future delivery (or an option on the contract of sale) or option on a commodity, ... (2) EXCEPTION. – Paragraph (1) shall not apply to a [DCO] that is registered with the [CFTC]”.

²⁹ See Section 5(d)(11)(A) of the CEA (requiring DCMs to ensure the clearing and settlement of DCM Futures with a DCO); see also CFTC Rule 38.601(a) (“Transactions executed on or through [a DCM] must be cleared through a [CFTC]-registered [DCO] in accordance with” the CFTC’s Part 39 Rules).

³⁰ See In the Matter of the Application of LCH.Clearnet Limited For Registration As a Derivatives Clearing Organization: Amended Order of Registration (December 16, 2014).

Separately, Section 4(b)(2)(C) of the CEA does not require DCO registration for foreign clearing organizations that clear Foreign Futures on, or subject to the rules of, an FBOT, regardless of the location of such foreign clearing organization's members or such members' customers.³¹ The term "FBOT" is defined in CFTC Regulation 48.2(a) as "any board of trade, exchange or market located outside the United States...whether incorporated or unincorporated", which is broad enough to include the Rates Exchanges participating in the Listed Rates Clearing Service. The term "Foreign Futures" includes any product listed for trading by an FBOT that is designated as a "futures" contract. Accordingly, LCH may provide the Listed Rates Clearing Service to Relevant Clearing Members to clear for their own proprietary accounts as well as for customers located in the United States without being required to extend its DCO registration to do so.³²

Securities

Section 17A(b) of the Exchange Act requires that any person that performs the activities of a "clearing agency"³³ through the use of U.S. jurisdictional means must register as such with the SEC.³⁴ On a plain reading, the requirement of Section 17A(b) would appear to cover foreign clearing organizations – such as LCH – providing securities clearing services to Relevant Clearing Members (or their customers), because such activities necessarily implicate the use of U.S. jurisdictional means. However, the SEC has established a policy that only requires a foreign clearing organization to register as a securities clearing agency to the extent that it provides clearance and settlement services "for U.S. securities directly to U.S. persons".³⁵

For these purposes, a "U.S. person" has traditionally included any person having a U.S. residence, based on the location of its executive office or principal place of business, including: (i) a U.S. bank (as defined in Section 3(a)(6) of the Exchange Act); (ii) a foreign branch of a U.S. bank or a

³¹ CEA Section 4(b)(2)(C) generally provides that "no rule or regulation may be adopted by the [CFTC] that (i) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market; or (ii) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market".

³² Where an FBOT provides "direct access" (defined in CFTC Rule 48.2 as "an explicit grant of authority...to enter trades directly into the trade matching system of" the FBOT) to persons located in the United States, it must register with the CFTC under Part 48 of the CFTC Regulations. To be registered, an applicant FBOT must demonstrate that its clearing organization is either registered with the CFTC as a DCO or otherwise complies with the CPMI-IOSCO Principles for Financial Market Infrastructures (as the successor standards to the CPMI-IOSCO Recommendations for Central Counterparties). *See* CFTC Rule 48.7(d).

³³ The term "clearing agency" is defined in Section 3(a)(23) of the Exchange Act to include, *inter alia*, "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities". LCH's RepoClear Service brings it within the definition of "clearing agency".

³⁴ For the sake of completeness, we note that futures contracts with U.S. treasuries as the underlying reference asset may be traded on a DCM and cleared on a DCO without imposing Exchange Act registration requirements on the DCM or DCO. *See* Section 2(a)(1)(C)(iv) of the CEA. Such futures contracts may also be physically settled. *See* Section 2(a)(1)(C)(ii)(I) of the CEA.

³⁵ This policy was reaffirmed in May 2013. *See* "Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants; Proposed Rule", 78 Fed. Reg. 30968, n. 682 (May 23, 2013).

U.S. BD; and (iii) any registered BD wherever located.³⁶ The scope of this definition was confirmed in the SEC's order exempting ICE Clear Europe Limited from clearing agency registration.³⁷ Based on this line of authority, each Relevant Clearing Member should qualify as a "U.S. person" for purposes of the SEC policy on registration of foreign clearing agencies.

By contrast, the SEC has not expressly defined what constitutes a "U.S. security" for these purposes. The initial set of SEC exemptive orders issued to non-U.S. clearing organizations involved the clearing of U.S. government debt and agency-backed mortgage securities.³⁸ In the Euroclear Notice, the SEC repeated, without comment, Euroclear's position that providing clearing services in respect of "foreign and internationally-traded" securities falls outside the scope of the registration requirements of Section 17A of the Exchange Act.³⁹ For these purposes, "foreign and internationally-traded securities" include: (i) debt and equity securities issued by foreign private and governmental issuers that trade principally in their home markets and/or internationally; and (ii) Euro and globally-distributed debt securities and global depositary shares issued by U.S. issuers in an international offering, whether registered under the Securities Act of 1933, as amended ("**Securities Act**") or pursuant to an exemption from such registration requirements. In reliance on this position, Euroclear has continued to clear "internationally-traded" securities of U.S. issuers for its U.S. participants without any interference from the SEC.

We understand that none of the securities relating to RepoClear Repo Transactions and RepoClear Bond Transactions involve U.S. government or agency-backed instruments or the issuances of any U.S. issuer. Accordingly, we are of the view that LCH's RepoClear Service for Relevant Clearing Members should not be characterized as providing clearing or settlement services directly to U.S. persons in respect of "U.S. securities", and hence should not require LCH to be registered as a clearing agency with the SEC.

5.1.3 What type of documents should be obtained by LCH to evidence that a Relevant Clearing Member and its officers have the capacity and authority to enter into the LCH Agreements? Is LCH required to verify such evidence?

Under applicable New York entity statutes, an entity's corporate power, limited liability company power or limited partnership power, as applicable, is generally defined in its organizing documents (including, as applicable, certificate of incorporation, by-laws, certificate of limited partnership, partnership agreement, articles of organization or operating agreement).

³⁶ See Exchange Act Release 34-39643, 63 Fed. Reg. 8232, n. 62 (February 18, 1998) ("**Euroclear Order**") (identifying "U.S. participants" for purposes of an order exempting Morgan Guaranty Trust Company – the predecessor of Euroclear Bank – from clearing agency registration).

³⁷ See Exchange Act Release 34-69872, 78 Fed. Reg. 40220, n. 15 (July 3, 2013) ("**ICE Clear Europe Order**") (defining "U.S. participants" to include any person that: (i) is an FCM or BD; (ii) is organized under the laws of the United States; or (iii) has a U.S. residence based on the location of its executive office or principal place of business including without limitation a U.S. bank (as defined in Section 3(a)(6) of the Exchange Act, or a foreign branch of a US bank or a U.S. registered BD).

³⁸ See, e.g., the Euroclear Order; Exchange Act Release 34-38589, 62 Fed. Reg. 26833 (May 15, 1997) ("**Euroclear Notice**") (notice that Morgan Guaranty Trust Company (as operator of the Euroclear system) requesting an exemption leading to the Euroclear Order); and Exchange Act Release 34-38238, 62 Fed. Reg. 9225 (February 28, 1997) (order exempting Clearstream Bank from clearing agency regulation in respect of clearing U.S. government debt securities).

³⁹ Euroclear Notice at n. 16.

For an entity incorporated or organized in New York to be bound by a transaction, the transaction must comply with the stated business purpose of the entity or, if applicable, fall within a general purpose clause permitting the entity to engage in any act or activity for which the applicable entity may be formed under New York law. If a general purpose clause is contained in the organizing documents, it will only be necessary to determine whether the activities covered by the LCH Agreements are outside of those permitted by a general purpose clause.

Under New York law, an entity is validly represented by its board of directors, its other authorized managers or members or its general partner, as applicable. In addition, the entity's organizing documents may grant powers of representation to one or more other persons. The entity may also be represented by a person who is authorized pursuant to a meeting of the board of directors, members or managers, as applicable, or authorized in a written consent of an authorized body.

With respect to authorization of entities to enter contracts under New York law, due diligence includes checking the applicable entity law in effect at the time the transaction was authorized, the document of formation and, for corporations, the Bylaws and the applicable minutes of the meeting at which authorization took place, including applicable notices or waivers of notice, or, for other entities, the operating or partnership agreement and authorization documents, if any. While not required, additional due diligence could include requesting a certified copy of certain organizational documents from the state in which the entity is organized.

5.1.4 Are there any formalities to be complied with upon entry into of any of the LCH Agreements and, if so, what is the effect of a failure to comply with these? Please consider in particular any formalities to be complied with to enter into the Deed of Charge and Security Deed.

In addition to the basic requirements of a valid contract, no specific formalities apply to the entry into the LCH Agreements (including the Deed of Charge and Security Deed) by a Relevant Clearing Member under the laws of the State of New York.

5.1.5 Would the courts of the Relevant Jurisdiction uphold the contractual choice of law and jurisdiction set out in Regulation 51?

Under New York law, it is well settled that choice of law clauses are presumptively valid where the underlying transaction is fundamentally international in character. *Roby v. Corp. of Lloyd's*, 996 F.2d 1353, 1362 (2d Cir. 1993) (citing *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972) (reasoning that choice of law clauses eliminate uncertainty in international commerce)).⁴⁰ Moreover, the United States Court of Appeals for the Second Circuit (the jurisdiction of which includes the State of New York) has made clear that this presumption may only be overcome in limited circumstances suggesting that: (i) the clause is unreasonable, such as fraud or overreaching; (ii) the chosen law will deny plaintiff of a remedy; or (iii) the clause contravenes a strong public policy of the forum state. *Id.* at 1363 (citations omitted). As a general matter, the most likely

⁴⁰ The focus of the instant analysis is on the likely treatment of the LCH Agreements in a federal court applying New York state law. However, New York state courts have similarly held that parties' agreements to submit to the jurisdiction of foreign courts are *prima facie* valid and enforceable, and will not be given effect only if the jurisdiction has no substantial relationship to the parties, application of the chosen law would strongly contravene the public policies of New York, or the clause was unfair or resulted from fraud. See, e.g., *MBIA Ins. Corp. v Royal Bank of Canada*, 958 N.Y.S.2d 62 (N.Y. Sup. Ct. 2010); *Hunt v. Landers*, 309 A.D.2d 900 (N.Y. App. Div. 2003).

defenses to application of English law in this case would appear to be the contravention of public policy and/or the denial of a remedy through the operation of English law.⁴¹

In considering whether the application of English law would contravene a strong public policy, a federal court applying New York state law will undertake one of two analyses depending on the jurisdictional basis of the court. First, where jurisdiction is based on the determination of a federal question, the court will consider federal common law, or more specifically, the purposes and goals of the specific law(s) and regulatory scheme at issue. *See Roby*, 996 F.2d at 1364 (weighing the investor protections provided by United States and UK securities law). Although this analysis is dependent on the actual claims made, it is a well-settled principle that “federal courts give substantial weight to choice of law provisions”. *Phillips v. Audio Active Ltd.*, 494 F.3d 378, 384 (2d Cir. 2007); *see also Skippers & Maritime Serv. Ltd. v. KfW*, No. 06 Civ. 7041, 2010 WL 882991, at *2 (S.D.N.Y. Mar. 5, 2010) (“[g]enerally, courts are deferential to choice-of-law provisions in international agreements”).

Conversely, where the federal court is sitting in diversity,⁴² the validity and scope of a choice of law provision will be determined based on New York state law. *Trade Wind Distrib., LLC v. Unilux AG*, No. 10 Civ. 5716, 2011 WL 4382986, at *3 (E.D.N.Y. Sept. 20, 2011). As is relevant here, New York choice-of-law authority recognizes choice of law designations provided that they are not arbitrary, but rather, based on some recognized connection between the transaction and the laws of the state or country chosen. *See generally Allstate Ins. Co. v. Stolarz*, 81 N.Y.2d 219 (N.Y. 1993) (considering the place of contracting, negotiation and performance; the location of the subject matter of the contract; and the domicile of the contracting parties); *Int’l Minerals & Res., S.A. v. Pappas*, 96 F.3d 586, 592 (2d Cir. 1996) (reasoning that England had sufficient contacts with the disputed transaction as it was the forum of choice designated in the contract and such transaction was conducted through the activities of the seller’s London brokers). In this respect, LCH’s provision of the Relevant Clearing Services from its London place of business should represent a sufficient connection between the LCH Agreements and English law to meet the requisite standard.

The other relevant consideration at bar is whether the application of English law would deny a plaintiff of a remedy under the law. *Roby*, 996 F.2d at 1363. As with public policy considerations, this analysis is highly fact specific, but will generally compare the relief available to a plaintiff under both English and United States law. Significantly, “it is not enough that the foreign law or procedure merely be different or less favorable than that of the United States”. *Id.* (citations omitted). Instead, the question is whether the application of the foreign law presents a danger that the litigant “will be deprived of *any* remedy or treated unfairly”. *Id.* (citing *Piper Aircraft Co. v. Reyno*, 454 U.S. 235, 254-55 (1981) (emphasis in original)). It is unlikely that a Relevant Clearing Member would be able to make a plausible claim for lack of a remedy under English law.

⁴¹ It is presumed for purposes of this Memorandum that the acceptance of the terms of the LCH Agreements by Relevant Clearing Members is not procured through fraud or overreaching and that litigation in the designated forum (*i.e.*, England) would not be impossible for a potential plaintiff. *See Bluefire Wireless, Inc. v. Cloud9 Mobile Commc’ns, Ltd.*, No. 09 Civ. 7268, 2009 WL 4907060, at *4 (S.D.N.Y. Dec. 21, 2009).

⁴² U.S. federal courts may exercise jurisdiction over disputes based on the “diversity of citizenship” of the litigants, for example where the parties are citizens of different States of the United States or the dispute is between a citizen of the United States and a citizen of a foreign jurisdiction.

5.1.6 Will the courts uphold the judgment of the English courts or an English arbitration award?

There are different sources of law for determining whether the courts in the Relevant Jurisdiction will uphold the judgments of English courts or English arbitration awards.

English Court Judgments

There is no U.S. federal law that governs the enforcement of foreign judgments in U.S. courts, which is instead subject to adjudication under state law. In New York, state courts “generally will accord recognition to judgments rendered in a foreign country under the doctrine of comity”.⁴³ *Greschler v. Greschler*, 51 NY2d 368, 376 [1980]. The court in *Greschler* cited to, *inter alia*, § 98 Restatement, Conflict of Laws 2d, which states that “[a] valid judgment rendered in a foreign nation after a fair trial in a contested proceeding will be recognized in the United States so far as the immediate parties and the underlying claim are concerned”.

Apart from the common law doctrine of comity, New York law provides for specific rules in relation to the recognition and enforcement of foreign money-award judgments.⁴⁴ Article 53 of New York’s Civil Practice Law and Rules (“CPLR”) codifies the Uniform Foreign Money Judgments Recognition Act under New York state law, and generally provides that a foreign judgment that is “final, conclusive, and enforceable where rendered” will also be enforceable in New York.⁴⁵ CPLR 5304(a) states that a foreign judgment is not “conclusive”, and therefore will not be recognized in New York, where the foreign country fails to provide impartial tribunals or due process, or where the foreign court lacked personal jurisdiction over the defendant.⁴⁶ A New York court must recognize that the foreign court had jurisdiction in the circumstances set out in CPLR 5305, including where the parties agreed prior to the start of the relevant proceedings to submit to the jurisdiction of the foreign court. The submission by a Relevant Clearing Member (other than an FCM Clearing Member) to the jurisdiction of the English courts in the Rulebook and the CM Agreement would therefore preclude a New York court from refusing to recognize a English court judgment on the basis that the English courts lacked personal jurisdiction over the Relevant Clearing Member.⁴⁷

⁴³ The rationale behind invoking the doctrine of comity is to align the enforcement of foreign judgments in New York courts with the obligation on New York courts under the “full faith and credit” clause of the U.S. Constitution to recognize court judgments from other U.S. states.

⁴⁴ A “money award judgment” means any judgment granting or denying recovery of a sum of money, other than a judgment for taxes, a fine or other penalty, or a judgment for certain family law issues.

⁴⁵ CPLR 5302. A qualifying foreign judgment will be enforceable in New York notwithstanding that an appeal from such judgment is pending or that an appeal may be made under local law in the foreign jurisdiction. *Id.*

⁴⁶ CPLR 5304(b) contains a list of discretionary grounds for a New York court to refuse to recognize a foreign judgment, including: (i) the foreign court lacked subject matter jurisdiction; (ii) the defendant did not receive timely notice of the foreign proceedings sufficient to enable him to defend; (iii) the foreign judgment was obtained by fraud; (iv) the cause of action on which the foreign judgment is based is repugnant to the public policy of this state; (v) the foreign judgment conflicts with another final and conclusive judgment; (vi) the proceeding in the foreign court was contrary to an agreement between the parties under which the dispute in question was to be settled otherwise than by proceedings in that court; and (vii) in the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum for the trial of the action.

⁴⁷ We note in this regard that FCM Clearing Members execute an FCM-specific form of CM Agreement and are subject to the FCM Rulebook, both of which are governed by the law of the State of New York, and therefore fall outside the scope of our response.

We are unaware of any case in which a New York court refused to recognize an English court judgment on the basis that English law fails to provide impartial tribunals or due process. To the contrary, New York courts have noted that New York has “traditionally been a generous forum in which to enforce judgments for money damages rendered by foreign courts”. *Sung Hwan Co., Ltd. v. Rite Aid Corp.*, 7 NY3d 78, 82 [2006], quoting *CIBC Mellon Trust Co. v. Mora Hotel Corp.*, 100 NY2d 215, 221 [2003]. Accordingly, an English court judgment under the LCH Agreements should generally be recognized and enforced by New York courts, provided that the facts and circumstances of the case do not implicate any of the discretionary grounds for refusing recognition set out in CPLR 5304(b).

In addition, under New York law, there is a “public policy” exception to the recognition and enforcement of foreign judgments under both the common law doctrine of comity as well as under the CPLR. However, the public policy exception has only been invoked in New York courts “in the rare instance ‘where the original claim is repugnant to fundamental notions of what is decent and just in the state where enforcement is sought’”. *Greschler*, 51 NY2d at 377 (quoting from Comment *c* to § 117 Restatement, Conflict of Laws 2d). Accordingly, the public policy exception will only apply where the enforcement of a foreign judgment by a New York court would result in the recognition of a “transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense”. *Intercontinental Hotels Corp. [Puerto Rico] v. Golden*, 15 NY2d 9, 13 [1964].⁴⁸

Although we are unaware that any New York court has considered the public policy exception in the circumstances addressed in this Memorandum, execution of the CM Agreement and submission to the Rulebook by Relevant Clearing Members is intended to facilitate access by sophisticated U.S. financial market participants to well-regulated international financial market infrastructures. New York courts have in the past indicated the strong public policy interest of the State of New York in maintaining its position as a global commercial and financial center, *see, e.g., Ehrlich-Bober & Co., Inc. v. University of Houston*, 49 NY2d 574, 581 (1980) (referring to “New York’s recognized interest in maintaining and fostering its undisputed status as the preeminent commercial and financial nerve center of the Nation and the world”), a policy which should make it more, rather than less, likely that a New York court would recognize and enforce a foreign judgment relating to the contractual obligations governing the relationship by such U.S. persons with their non-U.S. counterparties. Accordingly, we believe it unlikely that a New York court would invoke the public policy exception to deny recognition or enforcement of an English court judgment under the LCH Agreements.

English Arbitration Awards

In the United States, the U.S. Federal Arbitration Act (“FAA”)⁴⁹ gives authority to the U.S. federal courts to enforce foreign arbitral awards governed by the 1958 Convention on the Recognition and

⁴⁸ New York courts have also refused to enforce a foreign judgment on public policy grounds where the judgment involved a protected constitutional right in the United States where the burden of proof is reversed in the foreign court. *Bachchan v. India Abroad Publications, Inc.*, 585 NYS2d 661 (Sup.Ct. NY County 1992).

⁴⁹ 9 USC 1 et seq.

Enforcement of Foreign Arbitral Awards (“**New York Convention**”).⁵⁰ Specifically, Chapter 2 of the FAA expressly incorporates the terms of the New York Convention into U.S. federal law.⁵¹

An English arbitration award issued pursuant to the dispute resolution provisions in the Rulebook would constitute a “foreign arbitral award” in the United States for purposes of the New York Convention.⁵² Accordingly, such award would be enforced by the U.S. federal courts to the extent provided for in the FAA.⁵³

The FAA requires that, to be enforced in the United States, a foreign arbitral award meet certain basic conditions: the arbitration agreement arose out of a legal relationship; the arbitration agreement was in writing; and both countries are signatories of the New York Convention.⁵⁴ Where this limited set of basic conditions is met, the FAA provides that the foreign arbitral award must be enforced by U.S. federal courts unless one of the grounds for refusal of enforcement under the New York Convention applies.⁵⁵

The grounds for refusing to enforce a foreign arbitral award are as follows:

- the parties to the foreign arbitral award either lacked capacity or the award is not valid under the law of the jurisdiction in which the award was made;
- failure to provide proper notice of the arbitration to the party against whom the foreign arbitral award is to be enforced;
- the foreign arbitral award exceeds the scope of the parties’ agreement to arbitrate;
- the composition of the arbitral authority, or the procedure in making the award, differed from the parties’ agreement or did not otherwise accord with the law of the jurisdiction in which the award was made;
- the foreign arbitral award is not yet binding or has otherwise been stayed or set aside by a competent authority in the jurisdiction in which the award was made;

⁵⁰ See *Sole Resort, S.A. de C.V. v. Allure Resorts Mgmt., LLC*, 450 F.3d 100, 102 n.1 (2d Cir. 2001) (“the FAA and the New York Convention work in tandem, and they have overlapping coverage to the extent that they do not conflict”) (internal quotation marks omitted).

⁵¹ See 9 USC § 201 (“The [New York Convention] shall be enforced in the United States in accordance with this chapter”); § 203 (“An action or proceeding falling under the [New York] Convention shall be deemed to arise under the laws and treaties of the United States. The district courts of the United States . . . shall have original jurisdiction over such an action or proceeding . . .”).

⁵² See Article I of the New York Convention (“This Convention shall apply to the recognition and enforcement of arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought . . .”).

⁵³ We assume for purposes of our analysis that any such arbitral award is validly made and binding on the parties pursuant to the applicable provisions of English law (*e.g.*, the Arbitration Act 1996).

⁵⁴ We note in this regard that both the United States and United Kingdom are signatories to the New York Convention.

⁵⁵ 9 USC § 207.

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- the law of the jurisdiction in which the award is to be enforced does not permit the subject matter of the foreign arbitral award to be settled by arbitration; and
- the recognition or enforcement of the foreign arbitral award would be contrary to the public policy of the jurisdiction in which the award is to be enforced.

In the United States, the relevant case law contains repeated references to a federal policy favoring arbitration, and by extension the enforcement of foreign arbitral awards under the FAA.⁵⁶ In light of this policy, U.S. federal courts have placed a high burden on any party seeking to avoid enforcement of a foreign arbitral award in the United States by reliance on one of the foregoing grounds for refusing to enforce an award.⁵⁷

For example, in respect of the “public policy” ground for refusing to enforce a foreign arbitral award, the Second Circuit Court of Appeals has clearly stated that such exception only applies “where enforcement would violate our most basic notions of morality and justice”.⁵⁸ Moreover, neither erroneous reasoning by the arbitral authority nor a manifest disregard for the law is sufficient to refuse to enforce a foreign arbitral award in the United States on public policy grounds.⁵⁹ We are similarly unaware of any provision of U.S. federal or New York State law that would prohibit LCH and the Relevant Clearing Members from settling by arbitration the matters covered by the dispute resolution provisions of the Rulebook.

Therefore, in light of the strong presumption under the FAA of enforcing foreign arbitral awards, and the exceptionally unlikely event that a valid and binding arbitration award made under English law would implicate any of the grounds for refusal of enforcement under the New York Convention, it is our view that a U.S. federal court, after full consideration of all relevant factors as well as legal and equitable principles, would ordinarily enforce an English arbitration award made pursuant to the dispute resolution provisions of the Rulebook.

⁵⁶ See *Telenor Mobile Commc'ns AS v. Storm LLC*, 584 F.3d 396, 405 (2d Cir. 2009) (“*Telenor*”) (quoting *Encyclopaedia Universalis S.A. v. Encyclopaedia Britannica, Inc.*, 403 F.3d 85, 90 (2d Cir. 2005) (“*Encyclopaedia*”)) (“Given the strong public policy in favor of international arbitration, review of arbitral awards under the New York Convention is very limited in order to avoid undermining the twin goals of arbitration, namely, settling disputes efficiently and avoiding long and expensive litigation”).

⁵⁷ See *Europcar Italia, S.p.A. v. Maeillano Tours, Inc.*, 156 F.3d 310, 313 (2d Cir. 1998) (“*Europcar*”) (“The party opposing enforcement has the burden of proving the existence of one of these enumerated defenses”); see also *Encyclopaedia*, 403 F.3d at 90 (“The burden is a heavy one, as the showing required to avoid summary confirmation is high”) (internal quotations omitted).

⁵⁸ *Telenor*, 584 F.3d at 411 (quoting *Europcar*, 156 F.3d at 315).

⁵⁹ See *NTT DoCoMo, Inc. v. Ultra d.o.o.*, 2010 WL 4159459, at *2 (S.D.N.Y. 2010) (“The [public policy] exception is a narrow one and [e]rroneous legal reasoning or misapplication of the law is generally not a violation of public policy within the meaning of the New York Convention”) (quoting *Karaha Bodas Co. v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara*, 364 F.3d 274, 306 (5th Cir. 2004)). *Id.* (“Even a ‘manifest disregard [of the law] . . . does not rise to the level. . . to deny confirmation’ under” the public policy exception (quoting *M&C Corp. v. Erwin Behr GmbH & Co.*, 87 F.3d 851 n. 2 (6th Cir. 1996) (citing *Int'l Standard Elec. Corp. v. Bridas Sociedad Anonima Petrolera*, 745 F.Supp. 172, 181 (S.D.N.Y. 1990)).

5.1.7 Are there any “public policy” considerations that the courts of the Relevant Jurisdiction may take into account in determining matters related to choice of law and/or the enforcement of foreign judgments?

The relevant public policy considerations are set out in the responses in sections 5.1.5 and 5.1.6 above.

5.2 Insolvency, Security, Set-Off and Netting

5.2.1 Please identify the different types of Insolvency Proceedings and Reorganization Measures. Would any of these not be covered by those events entitling LCH to liquidate, transfer or otherwise deal with Contracts as provided for in Rule 3 or Rule 5 of the Default Rules? Are any other events or procedures not envisaged in Rule 3 or Rule 5 of the Default Rules relevant?

For the purposes of this Memorandum, the term “**Insolvency Proceedings**” applicable to Relevant Clearing Members will include proceedings under the U.S. Bankruptcy Code (the “**Code**”),⁶⁰ the U.S. Securities Investor Protection Act of 1970 (“**SIPA**”),⁶¹ the U.S. Federal Deposit Insurance Act (“**FDIA**”),⁶² and under the Orderly Liquidation Authority (“**OLA**”) set out in Title II of the Dodd-Frank Act⁶³ (collectively, the “**Statutory Regimes**”).

Under the applicable Statutory Regimes, neither BDs nor FCMs may file for reorganization; they may only be liquidated. As discussed below, however, a bank may be placed in conservatorship and operated as a going concern. As used in this Memorandum, therefore, the term “**Reorganization Measures**” refers only to conservatorship under the FDIA.

As noted above, for the purposes of this Memorandum we have assumed that a Relevant Clearing Member will be either an FCM Clearing Member, BD Clearing Member, Bank Clearing Member or Non-Bank SD Clearing Member. There are separate Statutory Regimes available governing the insolvency of each of those types of entities:

- With respect to the insolvency of an FCM Clearing Member, subchapter IV of chapter 7 of the Code provides for the liquidation of the insolvent FCM Clearing Member.
- With respect to the insolvency of a BD Clearing Member, SIPA provides for the institution of an insolvency proceeding against such insolvent BD Clearing Member.
- With respect to the insolvency of Bank Clearing Members (which for purposes of this Memorandum includes swap dealers that are U.S. regulated banks), the FDIA provides for the institution of a receivership proceeding to liquidate and wind up the affairs of the insolvent bank.

⁶⁰ 11 USC §§ 101-1532.

⁶¹ 15 USC §§ 78aaa-78lll.

⁶² 12 USC §§ 1811-1835a.

⁶³ 12 USC §§ 5301-5641.

- The insolvency of a Non-Bank SD Clearing Member will be subject to the provisions of the Code.

The foregoing notwithstanding, a Relevant Clearing Member determined to be in default or in danger of default under Section 203 of the Dodd-Frank Act could be subject to liquidation under the OLA provisions of Title II of the Dodd-Frank Act, pursuant to which the U.S. Federal Deposit Insurance Corporation (“**FDIC**”) would be appointed as its receiver.

We are of the view that the Statutory Regimes and OLA, as the Insolvency Proceedings and Reorganization Measures of the Relevant Jurisdiction, are all included within the events entitling LCH to liquidate, transfer or otherwise deal with Relevant Contracts as permitted under Rule 3 and Rule 5 of the Default Rules. In addition, LCH’s rights under Rule 3 and Rule 5 of the Default Rules may also be enforceable under the netting provisions of the Federal Deposit Insurance Corporation Improvement Act (“**FDICIA**”).

Each of the Statutory Regimes and the OLA are discussed in greater detail in section 5.2.3, *infra*. FDICIA is discussed in greater detail in section 5.2.5, *infra*. We are unaware of any other events or procedures not envisaged that would be relevant.

5.2.2 Would the Deed of Charge be effective in the context of Insolvency Proceedings or Reorganization Measures in respect of a Relevant Clearing Member? Is there anything that would prevent LCH from enforcing its rights under the Deed of Charge? Would LCH be required to take any particular steps or abide by any particular procedures for the purposes of enforcing against collateral provided to it by a Relevant Clearing Member under the Deed of Charge?

As discussed in more detail in section 5.2.3, *infra*, Section 362(b) of the Code extends protections from the Code’s automatic stay to include “any security agreement or arrangement or other credit enhancement related to” the classes of financial contracts that benefit from protections from the automatic stay. The protections afforded to so-called QFCs under the FDIA are similarly extended to include security agreements or arrangements or other credit enhancements related to a QFC.

For these purposes, a “security agreement” is defined as an “agreement that creates or provides for a security interest”.⁶⁴ A “security interest” is defined as a “lien created by an agreement” and a “lien” is defined as a “charge against or interest in property to secure payment of a debt or performance of an obligation”.⁶⁵ A central purpose of the Deed of Charge is for a Relevant Clearing Member to grant a security interest over certain of its property in favor of LCH in order to secure the performance and discharge of such Relevant Clearing Member’s obligations to LCH under the Rulebook and CM Agreement. In our view, this is a sufficient basis for the Deed of Charge to qualify as a “security agreement” for purposes of Section 362(b) of the Code and the QFC provisions of the FDIA. Accordingly, the Deed of Charge should benefit from all protections afforded by the foregoing provisions, as described in greater detail in section 5.2.3, *infra*.

⁶⁴ 11 USC § 101(50).

⁶⁵ *Id.* at § 101(37) (definition of “lien”), (51) (definition of “security interest”).

In the event of a non-insolvency Event of Default (or if, for any reason, the provisions of the Code or FDIA permitting LCH to exercise its rights under the Deed of Charge were determined by a U.S. court not to be available), LCH's rights under the Deed of Charge may nevertheless be enforceable under FDICIA, which is discussed in more detail in section 5.2.5, *infra*. Specifically, the protections made available under FDICIA to "members" of a "clearing organization" in respect of a "netting contract" also extend to any "security agreement or arrangement or other credit enhancement" relating to the netting contract.⁶⁶ FDICIA protections afforded to "netting contracts" entered into between two "financial institutions" are similarly extended to include "security agreements or arrangements or other credit enhancements" relating to such netting contracts.⁶⁷

For the reasons set out in section 5.2.5, *infra*, it is our view that the Default Rules are a "netting contract" for purposes of FDICIA. The Deed of Charge is clearly related to the Default Rules as the means by which LCH may enforce its security interest in the collateral deposited by the defaulting Relevant Clearing Member. Therefore, as a "security agreement" relating to a "netting agreement", the Deed of Charge should fall within the scope of the FDICIA protections available between: (1) two "members" of a "clearing organization"; and (2) two "financial institutions".

5.2.3 Would LCH have the right to take the actions provided for under the Default Rules (including exercising rights to deal with Contracts under Rule 6 and rights of set-off under Rule 8 but not at this stage considering those actions specifically provided for in the Client Clearing Annex to the Default Rules) in the event that a Relevant Clearing Member was subject to Insolvency Proceedings or Reorganization Measures? Is it necessary or recommended that LCH should be specific that certain Insolvency Proceedings and/or Reorganization Measures will constitute an Automatic Early Termination Event in accordance with Rule 3 of the Default Rules? If the answer is affirmative, please identify those specific Insolvency Proceedings and/or Reorganization Measures to which the answer applies and briefly explain your reasoning.

Subject to the remaining response below, LCH would have the right to take the actions provided for under the Default Rules, including exercising rights to deal with Relevant Contracts under Rule 6 and rights of set-off under Rule 8 (collectively, the "**Default Provisions**"), in the event of an insolvency proceeding of a Relevant Clearing Member under one of the Statutory Regimes. In addition, in light of the protections available to LCH under the Statutory Regimes and the general prohibition of *ipso facto* clauses under the Code, in our view it would not be necessary or recommended to specify that certain Insolvency Proceedings and/or Reorganization Measures constitute Automatic Early Termination Events.

Enforceability of the Default Provisions in a Bankruptcy Case of an FCM Clearing Member

FCMs may not file for reorganization; they may only be liquidated pursuant to subchapter IV of chapter 7 of the Code. Accordingly, the insolvency proceedings of an FCM Clearing Member will be governed by the Code.⁶⁸ Under the Code, the commencement of a bankruptcy case triggers an

⁶⁶ 12 USC § 4404(h).

⁶⁷ *Id.* at § 4403(f).

⁶⁸ For the sake of completeness, we note that most, if not all, Relevant Clearing Members will also be SEC-registered BDs, which are subject to insolvency proceedings pursuant to SIPA. 15 USC §§ 78aaa-78lll. Specifically, where the Securities Investor Protection Corporation ("**SIPC**") determines that a BD has failed or is in danger of failing to meet its obligations to customers,

automatic stay that enjoins most actions against the debtor and any of the debtor's property on account of claims that arose prior to the petition date. In most circumstances, the automatic stay prohibits: (1) the commencement or continuation of proceedings that could have been commenced prior to the petition; (2) the enforcement of pre-petition judgments; (3) acts to obtain possession of or exercise control over property of the estate; (4) acts to create, perfect, or enforce liens against property of the estate; (5) acts to collect, assess, or recover claims against the debtor; and (6) setoffs of pre-petition debts owed to the debtor against claims owed by the debtor.⁶⁹ The automatic stay remains in effect unless and until the U.S. Bankruptcy Court grants relief for cause at the request of a party in interest or the case is otherwise terminated.⁷⁰

Generally speaking, the Code prohibits the termination or modification of a contract, or of any right or obligation under such contract, at any time after the commencement of the case solely because of: "(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under [the Code]; or (C) the appointment of or taking possession by a trustee in a case under [the Code] or a custodian before such commencement".⁷¹ Similarly, Section 541(c)(1) of the Code provides that an interest of the debtor in property becomes property of the estate notwithstanding the inclusion of any such provision in a contract with the debtor. These generally unenforceable provisions of contracts are commonly known as "*ipso facto*" clauses.

The automatic stay and the unenforceability of *ipso facto* clauses are significantly limited, however, under certain provisions of the Code, which are discussed in turn below.

Section 556 of the Code: FCM Listed Interest Rates Contracts

Section 556 of the Code preserves the "contractual rights" of, *inter alia*, "commodity brokers" and "financial participants" to cause the liquidation, termination, or acceleration of "commodity contracts" as well as the right to payment of variation or maintenance margin in respect of open commodity contract positions, notwithstanding the bankruptcy filing. For the reasons set out below, in our view Section 556 will protect LCH's ability to enforce its rights under the Rulebook and the Default Rules, including in particular its rights under the Default Provisions to deal in FCM Listed Interest Rates Contracts that are DCM Futures and Foreign Futures and to terminate, net and set off amounts due and owing under such contracts.

The term "commodity broker" includes "clearing organizations...in respect of which there is a customer".⁷² The term "clearing organization" includes a DCO registered under the CEA. LCH's DCO registration extends to DCM Futures, whereas certain FCM Listed Interest Rates Contracts

SIPC may apply to a U.S. federal court for a protective order which, if granted, requires the court to appoint as trustee of the bankrupt BD "such persons as SIPC, in its sole discretion, specifies". 15 USC § 78eee. The trustee so appointed will, in respect of the FCM business of the insolvent BD, be subject to the same duties and requirements as a trustee under Chapter 7 of the Code, including the duties specified in Subchapter IV, as would apply to an insolvent FCM that is not also a registered BD. 15 USC § fff-1.

⁶⁹ 11 USC § 362(a).

⁷⁰ *Id.* at §§ 362(c)-(d).

⁷¹ *Id.* at § 365(e)(1).

⁷² *Id.* at § 101(6).

are traded on, or subject to the rules of, trading venues located outside the United States, *i.e.*, FBOTs.⁷³ Accordingly, LCH falls squarely within the definition of “clearing organization” – and hence “commodity broker” – in respect of FCM listed Interest Rates Contracts that are DCM Futures. However, in respect of FCM Listed Interest Rates Contracts that are Foreign Futures, LCH may not qualify as a “clearing organization” for purposes of the “commodity broker” definition in Section 556 of the Code and would need to qualify as a “financial participant” instead.

The term “financial participant” is defined in the Code to include any person who, at the time of a debtor’s insolvency, or at any time within the 15 months prior to such insolvency, has at least: (i) \$1,000,000,000 in total gross notional outstanding of “securities contracts”, “commodity contracts”, “forward contracts”, “repurchase agreements”, “swap agreements” or “master netting agreements” (each as defined in the Code) with counterparties that are not affiliates; or (ii) gross mark-to-market positions of not less than \$100,000,000 (aggregated across all counterparties that are not affiliates) in one or more such contracts.⁷⁴ According to LCH’s public website, as of April 14, 2020, the total gross notional amount of cleared interest rates swaps for one subset (client clearing) of one of LCH’s clearing services (SwapClear) was just under \$1.3 quadrillion, with total gross notional outstanding in such contracts at such date just under \$67 trillion. As LCH is the counterparty to each SwapClear Contract it clears, it is therefore our view that LCH has met the relevant thresholds to qualify as a “financial participant” for purposes of Section 556 of the Code.

The term “commodity contract” includes, in respect of a “futures commission merchant”, a “contract for the purchase or sale of a commodity for futures delivery on, or subject to the rules of, a contract market or board of trade”.⁷⁵ For these purposes, the terms “futures commission merchant”, “contract of sale”, “commodity”, “future delivery” and “board of trade” all have the meanings set out in the CEA. Each FCM Clearing Member is a “futures commission merchant” and each DCM is a “board of trade”.⁷⁶ Therefore, all FCM Listed Interest Rates Contracts that are DCM Futures qualify as “commodity contracts” for purposes of the Code.

The term “commodity contract” also includes, in respect of a “foreign futures commission merchant”, a “foreign future”.⁷⁷ For these purposes, a “foreign futures commission merchant” refers to any person engaged in soliciting or accepting orders in foreign futures and, in connection therewith, accepting cash or other assets (or extending credit) to margin, secure or guarantee any

⁷³ See In the Matter of the Application of LCH.Clearnet Limited For Registration as a Derivatives Clearing Organization (December 16, 2014).

⁷⁴ The term also includes a “clearing organization” as defined in Section 402 of FDICIA, which is discussed in greater detail in note 157 and accompanying text, *infra*.

⁷⁵ 11 USC § 764(4)(A).

⁷⁶ See, e.g., Section 5(a) of the CEA (referring to a “board of trade” as the type of entity eligible for designation as a contract market). The term “board of trade” is defined in Section 1a(6) of the CEA as any organized exchange or other trading facility. The term “organized exchange” is defined in Section 1a(37) of the CEA to generally mean a trading facility that has adopted certain rules to govern the conduct of participants and that has provided for certain disciplinary sanctions. A “trading facility” is defined in Section 1a(51) of the CEA to generally mean any physical or electronic facility in which multiple participants have the ability to execute transaction either by accepting bids or offers made by multiple participants on the facility or through the interaction of multiple bids and offers within a system with a pre-determined non-discretionary automated trade matching and execution algorithm.

⁷⁷ *Id.* at § 761(4)(B).

resulting trade or contract.⁷⁸ A “foreign future” refers to any futures contract traded on, or subject to the rules of, a board of trade outside the United States.⁷⁹ The Rates Exchanges all qualify as “boards of trade”⁸⁰ and are physically located outside the United States. Therefore the Foreign Futures listed for trading on Rates Exchanges should also qualify as “foreign futures” as defined in the Code, in which case FCM Clearing Members providing clearing services in respect of such contracts should qualify as “foreign futures commission merchants”.

In light of the foregoing analysis, all FCM Listed Interest Rates Contracts – including DCM Futures and Foreign Futures – should qualify as “commodity contracts”.

Finally, the term “contractual right” is defined in Section 556 to include any right set forth in a rule or bylaw of, *inter alia*, a “derivatives clearing organization” as defined in the CEA.⁸¹ We believe that LCH plainly falls within the definition of “derivatives clearing organization” set out in the CEA. Accordingly, in the event of the bankruptcy of an FCM Clearing Member, LCH, as a “clearing organization” (in respect of DCM Futures) and a “financial participant” (in respect of Foreign Futures), will be permitted to enforce its rights under the Rulebook and the Default Rules, including its rights under the Default Provisions to deal with such DCM Futures and Foreign Futures, and to set off or net any termination or payment amounts owed between it and the insolvent FCM Clearing Member.

FCM SwapClear Contracts and FCM ForexClear Contracts: Section 560 of the Code

Section 560 of the Code preserves the “contractual rights” of “swap participants” and “financial participants” to cause the liquidation, termination, or acceleration of “swap agreements” as well as

⁷⁸ *Id.* at § 761(12).

⁷⁹ *Id.* at § 761(11).

⁸⁰ *See* note 76 and accompanying text, *supra*.

⁸¹ The term “derivatives clearing organization” is defined in Section 1a(15) of the CEA and, unlike the definition of “clearing organization” for purposes of the definition of “commodity broker”, is not limited to DCOs registered with the CFTC:

(A) In general. The term “derivatives clearing organization” means a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction—

(i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;

(ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or

(iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.

(B) Exclusions. The term “derivatives clearing organization” does not include an entity, facility, system, or organization solely because it arranges or provides for—

(i) settlement, netting, or novation of obligations resulting from agreements, contracts, or transactions, on a bilateral basis and without a central counterparty;

(ii) settlement or netting of cash payments through an interbank payment system; or

(iii) settlement, netting, or novation of obligations resulting from a sale of a commodity in a transaction in the spot market for the commodity.

the right to offset and net out any termination values or payment amounts arising under, or in connection with, the termination, liquidation or acceleration of one or more swap agreements. For the reasons set out below, in our view Section 560 will protect LCH's rights under the Rulebook and the Default Rules, including its rights under the Default Provisions to deal in, and net and set off amounts due and owing under, FCM SwapClear and FCM ForexClear Contracts.

For the reasons set out in the immediately preceding section, we believe that LCH qualifies as a "financial participant" and is therefore eligible to enforce its contractual rights in respect of swap agreements with an insolvent FCM Clearing Member.

If, for any reason, LCH did not qualify as a financial participant, it may also enforce its rights under Section 560 as a "swap participant", which is defined as a counterparty to a "swap agreement".⁸² The term "swap agreement" is defined to include, *inter alia*, "any agreement...which is an interest rate swap ...[or] a currency swap".⁸³ FCM SwapClear Contracts are interest rate swaps and FCM ForexClear Contracts are currency swaps, which means that they are both "swap agreements" for purposes of the Code. LCH is therefore a "swap participant" in respect of both the FCM SwapClear Contracts as well as the FCM ForexClear Contracts it enters into with FCM Clearing Members.

Finally, the term "contractual right" is defined in Section 560 to include any right set forth in a rule or bylaw of, *inter alia*, a "derivatives clearing organization" as defined in the CEA.⁸⁴ For the reasons set out in the preceding discussion, LCH is a "derivatives clearing organization" set out in the CEA. Accordingly, in the event of the bankruptcy of an FCM Clearing Member, LCH, as both a "financial participant" and a "swap participant", will be permitted to enforce its rights under the Rulebook and the Default Rules, including its rights under the Default Provisions to deal in FCM SwapClear Contracts and FCM ForexClear Contracts and to set off or net any termination or payment amounts owed between it and the insolvent FCM Clearing Member.

Section 362(b) of the Code: Contractual Rights

Beyond the provisions of Section 556 and 560 of the Code discussed above, Section 362(b) of the Code provides further protections where a debtor enters into certain classes of contracts with certain counterparties; LCH should benefit from these protections in respect of FCM Listed Interest Rates Contracts (including DCM Futures and Foreign Futures) as "commodity contracts" and separately in respect of FCM SwapClear Contracts and FCM ForexClear Contracts as "swap agreements".

Section 362(b)(6) permits a "financial participant" (a term which includes LCH, described above) to exercise any "contractual rights" (as defined in Section 556 of the Code, described above) arising under the rules or bylaws of a DCO or otherwise to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with any "commodity contracts", such as the FCM Listed Interest Rates Contracts (including DCM Futures and Foreign Futures, described above). Section 362(b)(17) correspondingly permits a "swap participant" (a term which includes LCH, described above) to exercise any "contractual rights" (as defined in Section 560 of the Code, described above) arising under the rules or bylaws of a DCO or otherwise to offset or net

⁸² *Id.* at § 101(53C).

⁸³ *Id.* at § 101(53B).

⁸⁴ See note 81, *supra*.

out any termination value, payment amount or other transfer obligation arising under or in connection with any “swap agreements” (a term which includes FCM SwapClear and FCM ForexClear Contracts, described above).

In addition, these provisions permit LCH to exercise any “contractual rights” (as defined in Section 556 and 560 of the Code, respectively) in respect of any security agreement or credit enhancement forming a part or related to any “commodity contracts” or “swap agreements”, meaning in effect that LCH is permitted to utilize any margin, collateral or other credit support held in respect of FCM Listed Interest Rates Contracts (including DCM Futures and Foreign Futures), FCM SwapClear Contracts and FCM ForexClear Contracts.

Finally, a bankruptcy trustee appointed in respect of an insolvent FCM Clearing Member may not avoid any transfers that are margin payments or settlement payments made by or to (or for the benefit of), *inter alia*, a financial participant or a transfer that is made by or to (or for the benefit of), *inter alia*, a financial participant in respect of a commodity contract.⁸⁵ Similar limitations on the trustee’s avoidance powers apply in respect of transfers made by or to (or for the benefit of) a swap participant under or in connection with a swap agreement.⁸⁶ The only exception to this prohibition is in respect of fraudulent transfers as described in Section 548(a)(1)(A) of the Code, *i.e.*, where a transfer was made with actual intent to hinder or defraud creditors.⁸⁷

Sections 362(b)(27) and Section 561 of the Code: Master Netting Agreements

Given the safeguards available under Sections 362(b)(6), 362(b)(17), 556 and 560 of the Code discussed above, LCH should have significant protections against the operation of an automatic stay in the event of an insolvency of an FCM Clearing Member. However, Sections 362(b)(27) and 561 of the Code provide an additional exemption from the automatic stay as well as the preservation of contractual rights for “master netting agreement participants” in respect of “master netting agreements”. A “master netting agreement” is defined as “an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more [securities contracts, commodity contracts, forward contracts, repurchase agreements, or swap agreements] or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation related to 1 or more of the foregoing”.⁸⁸ A “master netting agreement participant” is defined as an entity that is a counterparty to a master netting agreement.⁸⁹

While the rules of a clearing organization are not expressly included within the scope of the term “master netting agreement”, there is precedent for clearing organizations to expressly identify their rules as a master netting agreement.⁹⁰ Although LCH does not expressly state that the FCM Rulebook is a “master netting agreement”, there is nothing in the definition of this term requiring

⁸⁵ 11 USC § 546(e).

⁸⁶ *Id.* at § 546(g).

⁸⁷ *Id.* at § 548(a)(1)(A).

⁸⁸ *Id.* at § 101(38A).

⁸⁹ *Id.* at § 101(38B).

⁹⁰ *See, e.g.*, CME Rule 818.C.

such a statement. Instead, the definition requires only that the agreement “[provide] for the exercise of rights”. The Default Rules provide LCH the right to take a number of actions in a default scenario – supplemented in respect of FCM Clearing Members by FCM Regulation 9(i) and FCM Regulation 37 – including terminating open FCM Contracts, netting the rights, obligations and positions of the insolvent clearing member and setting off amounts owing between LCH and the insolvent clearing member. We also note that FCM Regulation 37(f)(iii) states that the common intention of LCH and the FCM Clearing Members is to treat the FCM Rulebook as a “netting contract” for purposes of FDICIA; while the FDICIA and Code definitions are not identical, the statement in FCM Regulation 37(f)(iii) provides persuasive evidence that the FCM Rulebook does in fact provide for netting rights between LCH and each FCM Clearing Member.

We believe that the above-referenced provisions are sufficient for the Default Rules (including the FCM Rulebook) to constitute a “master netting agreement” and therefore LCH and the Relevant Clearing Members are “master netting agreement participants” for purposes of the protections made available under Section 362(b)(27) and Section 561 of the Code.

A master netting agreement participant may benefit from the exemption from the automatic stay and the right to enforce its contractual rights to the extent that such participant would be able to do so in respect of each individual transaction subject to the master netting agreement. In other words, the coverage of Section 362(b)(27) and Section 561 of the Code in respect of master netting agreements is coextensive with the provisions of Sections 362(b)(6), 362(b)(17), 556 and 560 discussed in the preceding section, further ensuring LCH’s rights in respect of FCM Listed Interest Rates Contracts (including DCM Futures and Foreign Futures), FCM SwapClear Contracts and FCM ForexClear Contracts.⁹¹

Enforceability of the Default Provisions in a SIPA Proceeding of a BD Clearing Member

The provisions of SIPA deal with the liquidation of a BD Clearing Member that has failed or is in danger of failing to meet its obligations to customers.⁹² If SIPC believes the prerequisites have been satisfied, SIPC will seek a protective decree from the U.S. federal District Court in which the BD Clearing Member has its principal place of business ordering the liquidation of such BD Clearing Member by a trustee appointed by the court. Once the District Court enters a protective decree, the SIPA proceeding is immediately transferred to the bankruptcy court for the district, which will then oversee the liquidation.

The filing of an application for a protective decree by SIPC with respect to a BD Clearing Member in the requisite financial difficulty immediately triggers the automatic stay of Section 362 of the Code with respect to property of the estate. (In addition, the decree traditionally entered by the District Court contains numerous stay provisions consistent with the automatic stay.) A SIPA proceeding is conducted in accordance with the provisions of the Code applicable to a liquidation

⁹¹ The bankruptcy trustee may not avoid any margin, settlement or other payment in respect of the above-referenced classes of FCM Contracts except in respect of any transfers made with actual intent to hinder or defraud creditors. 11 USC § 546(j).

⁹² An FCM Clearing Member or BD Clearing Member may also be registered as an SD. In the event such member were to become subject to an insolvency proceeding, it would be liquidated in accordance with the provisions of the subchapter IV of Chapter 7 of the Code or SIPA, as applicable.

under chapter 7 thereof except to the extent any such provisions are inconsistent with the provisions of SIPA.

There are a number of statutory exceptions to the automatic stay that are applicable in a SIPA proceeding. Of particular relevance is the exception provided by Sections 555 and 559 of the Code.

Section 555 of the Code

Section 555 of the Code preserves the “contractual rights” of, *inter alia*, a “financial participant” to terminate, accelerate and liquidate certain financial instruments, including “securities contracts”, where there has been a bankruptcy or insolvency default by a “stockbroker”. For these purposes, a BD Clearing Member is a “stockbroker”⁹³ and, for the reasons set out above, LCH qualifies as a “financial participant”.

“Securities contracts” are defined to include, *inter alia*, “a contract for the purchase, sale, or loan of a security”.⁹⁴ The term “security” is defined broadly to include a number of different instruments such as notes, stocks, bonds, debentures as well as “any other claim or interest commonly known as a ‘security’”. Accordingly, the term “security” under the Code should be congruent with the scope of the term “security” under the Exchange Act for purposes of this analysis, and so the RepoClear Repo Transactions and RepoClear Bond Transactions accepted for clearing by LCH – which involve the sale and purchase of “securities” – should all be “securities contracts” for purposes of the exception from the automatic stay. Any master agreement that provides for any other “securities contract” is itself a securities contract, and therefore the Rulebook (including the Default Provisions), as a master document providing for, *inter alia*, securities contracts, should also be a “securities contract” for purposes of the exception from the automatic stay.

The term “contractual right” is defined in Section 555 to include any right set forth in a rule or bylaw of, *inter alia*, a “derivatives clearing organization” as defined in the CEA, which includes LCH.⁹⁵ Accordingly, in the event of the bankruptcy of a BD Clearing Member, LCH, as a “financial participant”, will be permitted by Section 555 of the Code to enforce its rights under the Rulebook and the Default Rules, including its rights under the Default Provisions to deal in RepoClear Contracts and to offset or net any termination or payment amounts owed between it and the insolvent BD Clearing Member.

Section 559 of the Code

In parallel with the protections afforded to “securities contracts” described above, Section 559 of the Code preserves the “contractual rights” of a “repo participant” and a “financial participant” to terminate, accelerate and liquidate “repurchase agreements”. It is our view that LCH qualifies as a

⁹³ The term “stockbroker” is defined as any person that either: (1) has a “customer” (as defined in Section 741 of the Code); (ii) is engaged in the business of effecting transactions in securities for the account of others; or (iii) is engaged in the business of effecting securities transactions for or from its own account with members of the general public. 11 USC § 101(53A).

⁹⁴ 11 USC § 741(7)(A)(i).

⁹⁵ See note 81, *supra*.

“financial participant” as defined in the Code.⁹⁶ LCH will also qualify as a “repo participant” to the extent that it is a party to “repurchase agreements” with the Relevant Clearing Member.

“Repurchase agreements” are defined to include, *inter alia*, “an agreement . . . which provides for the transfer of one or more . . . qualified foreign government securities . . . against the transfer of funds by the transferee . . . with a simultaneous agreement by such transferee to transfer to the transferor thereof . . . interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand”.⁹⁷ For these purposes “qualified foreign government securities” includes any securities that are direct obligations of, or fully guaranteed by, the central government of a member of the Organization of Economic Cooperation and Development.⁹⁸ Accordingly, to the extent that the RepoClear Repo Transactions accepted for clearing by LCH meet the foregoing criteria, they will qualify as “repurchase agreements” for purposes of the exception from the automatic stay.⁹⁹ Any master agreement that provides for any other “repurchase agreement” is itself a repurchase agreement, and therefore the LCH Agreements (including the Default Provisions), as a master document providing for, *inter alia*, repurchase agreement, should also be a “repurchase agreement” for purposes of the exception from the automatic stay.

The term “contractual right” is defined in Section 559 to include any right set forth in a rule or bylaw of, *inter alia*, a “derivatives clearing organization” as defined in the CEA, which includes LCH.¹⁰⁰ Accordingly, in the event of the bankruptcy of a BD Clearing Member, LCH, as a “financial participant” and “repo participant”, will be permitted by Section 559 of the Code to enforce its rights under the Default Provisions to deal in RepoClear Contracts that qualify as “repurchase agreements” and to offset or net any termination or payment amounts owed between it and the insolvent BD Clearing Member in respect of such RepoClear Contracts.

Section 362(b) of the Code: Contractual Rights

As discussed above, Section 362(b) of the Code provides additional protections where a debtor enters into certain classes of contracts with certain counterparties. In particular, the right of “financial participants” to enforce their “contractual rights” under Section 362(b)(6) of the Code extends to “securities contracts”, which for the reasons set out above is a term that will include both the RepoClear Repo Transactions and the RepoClear Bond Transactions accepted for clearing by LCH. Accordingly, LCH will be able to exercise the rights afforded to it under the Rulebook and the Default Rules to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with the foregoing classes of securities contracts.

⁹⁶ See note 74 and accompanying text, *supra*.

⁹⁷ 11 USC § 101(47)(A)(i).

⁹⁸ *Id.*

⁹⁹ Based on our review of the eligibility criteria for the RepoClear Service, we believe that RepoClear Repo Transactions relating to “Government Debt Securities” with a tenor or less than 1 calendar year qualify as “repurchase agreements” within the meaning of Section 559 of the Code and are therefore eligible for the exception to the automatic stay.

¹⁰⁰ See note 81, *supra*.

Section 362(b)(7) provides corresponding protections to “repo participants” and “financial participants” in respect of “repurchase agreements”.¹⁰¹ Accordingly, to the extent that RepoClear Repo Transactions qualify as “repurchase agreements”¹⁰² then Section 362(b)(7) will provide an additional source of protection for LCH to enforce its rights against an insolvent BD Clearing Member in respect of such contracts.

The congruent protections available to master netting agreement participants in respect of master netting agreements under Section 362(b)(27) and Section 561 of the Code also covers by its terms master netting agreements in respect of securities contracts and repurchase agreements. Accordingly, for the reasons set out above, we believe that Default Rules (including the Rulebook) constitute a master netting agreement and LCH and the Relevant Clearing Members are master netting agreement participants, and therefore such protections should extend to cover LCH’s rights in respect of RepoClear Contracts.

Finally, the provisions of Section 546(e) of the Code that prevent a bankruptcy trustee from avoiding any transfers that are margin payments or settlement payments made by or to (or for the benefit of), *inter alia*, a financial participant or a transfer that is made by or to (or for the benefit of), *inter alia*, a financial participant, also extend to preventing such avoidance by a trustee appointed in respect of the securities contracts of an insolvent BD Clearing Member.¹⁰³ As noted in the preceding discussion, the only exception to this prohibition is in respect of a transfer made with actual intent to hinder or defraud creditors.¹⁰⁴

SIPA Safe Harbor

SIPA provides a similar, but somewhat broader, exception to the automatic stay (and one exception to the exception) that is relevant here. Specifically, similar to the safe harbor provisions of the Code with respect to securities contracts, SIPA provides that the automatic stay will not apply to:

any contractual rights *of a creditor* to liquidate, terminate, or accelerate a securities contract . . . or master netting agreement as those terms are defined [in the Code] to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more such contracts or agreements, or to foreclose on any *cash collateral* pledged by the debtor, whether or not with respect to one or more of such contracts or agreements.¹⁰⁵

This provision is broader than the safe harbor contained in Section 555 of the Code in that *any* creditor/counterparty to a securities contract, not just the types of counterparties specified in Section

¹⁰¹ 11 USC § 362(b)(7) (the automatic stay under the Code does not apply to “the exercise by a repo participant or financial participant of any contractual right (as defined in section 559) under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements”).

¹⁰² See note 99 and accompanying text, *supra*.

¹⁰³ See note 85, *supra*.

¹⁰⁴ See note 87, *supra*.

¹⁰⁵ 15 USC § 78eee(b)(2)(C)(i) (emphasis added).

555, can exercise these rights and, unlike the Code's safe harbor, the contractual right exercised by the counterparty does not have to be conditioned on an *ipso facto* provision.

Unlike the Code, however, SIPC has the right to seek a temporary stay of the liquidation or other disposition of securities collateral by a creditor or counterparty.¹⁰⁶ The prohibition against liquidating securities collateral is consistent with SIPA's mandate to return to customers the securities they held in their accounts at the commencement of the proceeding. While SIPA protective decrees typically recite this prohibition against the liquidation of securities collateral, that prohibition has been historically limited to a period of 21 days (although nothing precludes SIPC from requesting, or the District Court agreeing to impose, a shorter or longer period) and also typically provides that the SIPA trustee and SIPC may consent to modify the stay on a case-by-case basis if the securities collateral is not needed.

Accordingly, subject to such temporary stay with respect to the liquidation of securities collateral, in a SIPA proceeding commenced against a BD Clearing Member, a U.S. court having jurisdiction over such SIPA proceeding should hold that LCH has the right to deal in RepoClear Contracts and to set off or net any termination or payment amounts owed between it and the insolvent BD Clearing Member, in each case as provided for in the Default Provisions, notwithstanding the automatic stay extant pursuant to Section 362 of the Code or any other order entered in the SIPA proceeding.

Enforceability of the Default Provisions in a Proceeding under the FDIA

If the insolvent Relevant Clearing Member that is a state- or nationally-chartered banking or savings institution that takes FDIC-insured deposits, then the FDIA will likely govern conservatorship or receivership proceedings in respect of such Relevant Clearing Member ("**Insured Institution**").¹⁰⁷ The FDIA will also apply to any Insured Institution that is also an SD Clearing Member. While acting as conservator, the FDIC has the authority to operate the Insured Institution as a going concern. While acting as receiver, the FDIC has the authority to liquidate and wind up the affairs of the Insured Institution. Similar to proceedings under the Code, conservatorship or receivership proceedings under the FDIA generally impose limitations on the ability of counterparties to a contract with the insolvent Insured Institution to exercise otherwise enforceable contractual rights.

Such limitations include: (1) the FDIC, as conservator or receiver of the insolvent Insured Institution, has the ability to enforce or repudiate contracts, notwithstanding contractual provisions providing for termination, default, acceleration or exercise of rights upon insolvency or appointment of or the exercise of rights or powers by a conservator or receiver;¹⁰⁸ (2) the FDIC, as

¹⁰⁶ The stay would apply to the securities owned by both the BD Clearing Member and the BD Clearing Member's customers (if any).

¹⁰⁷ State law, including state law avoidance powers, may also apply in a conservatorship or receivership proceeding under the FDIA, especially in the case of a non-federalized proceeding for a state-chartered institution. The conservatorship and receivership provisions of the FDIA would not apply in the case of non-FDIC insured banks, thrifts, and branches or agencies of foreign banks (except, perhaps, in the case of a federal branch of a foreign bank). The conservatorship and receivership provisions of the FDIA might also not apply in the unlikely case of a non-FDIC conservator for a national bank acting under the Bank Conservation Act or in the case of a non-FDIC conservator for a thrift acting under the Home Owners Loan Act. The risk that the provisions of the FDIA would not apply to an FDIC-insured institution in conservatorship or receivership is quite small.

¹⁰⁸ 12 USC § 1821(e)(13). The FDIC's right to repudiate contracts is not expressly limited under the FDIA to "executory" contracts, as under Section 365 of the Code. The FDIC has taken the position in policy statements that its repudiation power extends to secured debt obligations and collateralized letters of credit. Case law is divided on this issue. *cf. IBJ Schroder Bank &*

conservator or receiver, may request and obtain a 45-day stay or a 90-day stay, respectively, of any “judicial” action;¹⁰⁹ (3) the consent of the FDIC as conservator or receiver may be necessary before a party may exercise any right to terminate, accelerate, or declare a default, or to obtain possession of or exercise control over any property of the Insured Institution or affect any contractual rights of the Insured Institution, during the 45-day period beginning on the date of the appointment of the conservator, or during the 90-day period beginning on the date of the appointment of the receiver, as applicable;¹¹⁰ and (4) the FDIC has the power to transfer assets and liabilities selectively, overriding contractual restrictions to the contrary and potentially destroying netting rights.¹¹¹

The Qualified Financial Contracts Provisions

The FDIA, however, contains exceptions that permit a counterparty to exercise its contractual rights with respect to qualified financial contracts (“QFCs”), as well as such counterparty’s rights under an security agreement or arrangement or other credit enhancement related to QFCs, against an Insured Institution that is in conservatorship or receivership under the FDIA.¹¹² The FDIA defines a QFC to mean any “securities contract”, “commodity contract”, “forward contract”, “repurchase agreement”, “swap agreement”, and any similar agreement that the FDIC determines by regulation, resolution or order to be a QFC for purposes of the FDIA.¹¹³ There are no material differences relevant to this Memorandum between the definitions of “securities contract”, “commodity contract”, “repurchase agreement” and “swap agreement” under the FDIA and the definitions of the corresponding terms under the Code described above. Accordingly, the Relevant Contracts addressed in this Memorandum, as well as the Deed of Charge, should qualify as QFCs. In addition, the Rulebook, as a master agreement providing for, *inter alia*, securities contracts, commodity contracts, repurchase agreements, and swap agreements, should qualify as a QFC in respect of all such contracts and agreements.

In general, QFC status protects the exercise of the Default Provisions as well as LCH’s rights under the Deed of Charge. For example, QFC status protects creditors from the need to obtain FDIC consent before exercising the right or power to terminate, accelerate, or declare a default under a

Trust Co., as Trustee v. RTC as Conservator for Franklin Savings Assoc., 26 F.3d 370 (2d Cir. 1994) (repudiation of secured bonds valid); *Howell v. FDIC*, 986 F.2d 569 (1st Cir. 1993) (repudiation of severance agreements). *But see LaMagna v. FDIC*, 828 F. Supp. 1 (D.D.C. 1993) (FDIC cannot repudiate non-executory contracts); *Marsa v. Metrobank*, 825 F. Supp. 658 (D.N.J. 1993) and *Fresca v. FDIC*, 818 F. Supp. 664 (S.D.N.Y. 1993) (court questioned but did not render a decision as to whether FDIC could ever repudiate a non-executory contract). *See also Security Pac. Nat’l Bank v. RTC*, 63 F.3d 900 (9th Cir. 1995) (upon repudiation of subordinated debt, debt holder’s claim remains subordinated); *Lawson v. FDIC*, 3 F.3d 11 (1st Cir. 1993) (characterizing a CD as an executory contract that could be repudiated).

¹⁰⁹ See 12 USC § 1821(d)(12). This stay of judicial actions (as opposed to the one-business-day stay discussed below) does not apply to a counterparty to a QFC (defined below) in connection with the exercise of its liquidation rights under the QFC.

¹¹⁰ See 12 USC § 1821(e)(13)(C)(i).

¹¹¹ See, e.g., *In re F&T Contractors, Inc.*, 718 F.2d 171 (6th Cir. 1983).

¹¹² See 12 U.S.C. § 1821(e)(8)(A).

¹¹³ See 12 USC § 1821(e)(8)(D)(i)-(vii). Each definition also expressly includes any “security agreement or arrangement or other credit enhancement related to” any of the foregoing classes of contracts and agreements. See 12 USC § 1821(e)(8)(D)(ii)(XII) (security agreement relating to securities contracts); 12 USC § 1821(e)(8)(D)(iii)(X) (security agreement relating to commodity contracts); 12 USC § 1821(e)(8)(D)(v)(VI) (security agreement relating to repurchase agreements); and 12 USC § 1821(e)(8)(D)(vi)(VI) (security agreement relating to swap agreements).

QFC, or to obtain possession of or exercise control over any property of the Insured Institution or affect any contractual rights of the Insured Institution, during the 45-day period beginning on the date of the appointment of the conservator, or during the 90-day period beginning on the date of the appointment of the receiver.¹¹⁴

While QFC status affords LCH many protections, the range of rights that it may exercise depends on whether the FDIC is acting as conservator or receiver of the Insured Institution.¹¹⁵

FDIC Conservatorship

In an FDIC conservatorship, LCH would generally be permitted to rely on QFC status to exercise its rights under the Default Provisions. Specifically, 12 USC § 1821(e)(8)(E) provides:

Notwithstanding any other provision of this chapter (other than subsections (d)(9) and (e)(10) of this section, and section 1823(e) of this title), any other Federal law, or the law of any State, no person shall be stayed or prohibited from exercising—

- (i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a depository institution in a conservatorship upon a default under such financial contract which is enforceable under applicable non-insolvency law;
- (ii) any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause (i);
- (iii) any right to offset or net out any termination values, payment amounts, or other transfer obligations arising under or in connection with such qualified financial contracts.¹¹⁶

Notwithstanding the general QFC protections applicable in an FDIC conservatorship, Section 1821(e)(10) of the FDIA imposes two primary impediments to the exercise of its rights under the

¹¹⁴ 12 U.S.C. § 1821(e)(13)(C)(ii).

¹¹⁵ In all cases, the provisions of the FDIA limit the enforceability of so-called “walkaway” clauses. 12 USC § 1821(e)(8)(G)(i). A walkaway clause includes:

any provision in a [QFC] that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of such party’s status as a nondefaulting party in connection with the insolvency of an insured depository institution that is a party to the contract or the appointment of or the exercise of rights or powers by a conservator or receiver of such depository institution, and not as a result of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law.

12 U.S.C. § 1821(e)(8)(G)(iii). In the case of a conservatorship, no exception exists to the unenforceability of walkaway clauses. In the case of a receivership, a walkaway clause will not be enforced as written; rather, payments under the QFC that would otherwise be due are suspended from the time of the receiver’s appointment until the earlier of: (i) the time that party not subject to receivership receives notice that its QFCs have been transferred; or (ii) 5:00 p.m. Eastern time on the business day following the date of the appointment of the receiver. 12 USC § 1821(e)(8)(G)(ii).

¹¹⁶ 12 USC § 1821(e)(8)(E).

Default Provisions in respect of QFCs. First, Section 1821(e)(10)(B)(ii) of the FDIA restricts the ability of a counterparty to exercise its rights under Section 1821(e)(8)(E) of the FDIA based solely upon the conservatorship of an Insured Institution:

A person who is a party to a [QFC] with an [Insured Institution] may not exercise any right that such person has to terminate, liquidate, or net such contract under paragraph (8)(E) of this subsection . . . solely by reason of or incidental to the appointment of a conservator for the [Insured Institution] (or the insolvency of or financial condition of the [Insured Institution] for which the conservator has been appointed).¹¹⁷

Second, Section 1821(e)(10)(A) of the FDIA, in conjunction with Section 1821(e)(9) of the FDIA, permits the FDIC, as conservator of the Insured Institution, to transfer all QFCs between a counterparty and its affiliates and the Insured Institution to another financial institution.¹¹⁸ If the FDIC elects to transfer a counterparty's QFCs with the Insured Institution, the provisions of the FDIA constrain its ability to make selective transfers. It must transfer either all or none of the QFCs between the Insured Institution and the counterparty and the counterparty's affiliates, all claims of the Insured Institution against the counterparty and its affiliates, and all property securing, or any other credit enhancement for, any of the foregoing.¹¹⁹ In the case of a transfer of QFCs to a foreign financial institution or a branch or agency of a foreign institution, transfers are permitted only if provisions related to the close-out and netting of the QFCs "are enforceable substantially to the same extent as permitted under [the FDIA]".¹²⁰ A counterparty, following a transfer of QFCs, would look to the transferee for performance on those QFCs.

In addition, the FDIC as conservator (or receiver) is entitled to repudiate an Insured Institution's QFCs. However, as with the transfer of QFCs, if the FDIC repudiates any of the Insured Institution's QFCs with a given counterparty, it must repudiate all of the Insured Institution's QFCs with that counterparty and that counterparty's affiliates.¹²¹ The FDIC's liability with respect to repudiated contracts is generally limited to actual direct compensatory damages determined, in the case of a QFC, as of the date of disaffirmance or repudiation of such QFC. With respect to repudiated contracts that are QFCs, such compensatory damages are expressly deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the

¹¹⁷ 12 USC § 1821(e)(10)(B)(ii).

¹¹⁸ Pursuant to the FDIA, the new counterparty must be a "financial institution", defined as a broker or dealer, a depository institution, a futures commission merchant, or any other institution, as determined by the FDIC by regulation to be a "financial institution". The FDIA specifically requires the FDIC as conservator or receiver not to make any transfer of QFCs to foreign financial institutions (including U.S. branches and agencies of foreign banks) unless it determines that the non-defaulting party will have close-out netting and collateral rights similar to those under the FDIA in an insolvency of the foreign financial institution. In the case of a transfer to a US financial institution, there is no such requirement. The FDIA further provides that, "[i]n the event that a conservator or receiver transfers any qualified financial contract and related claims, property, and credit enhancements . . . and such contract is cleared by or subject to the rules of a clearing organization, the clearing organization shall not be required to accept the transferee as a member by virtue of the transfer". 12 USC § 1821(e)(9)(C).

¹¹⁹ 12 USC § 1821(e)(9)(A).

¹²⁰ 12 USC § 1821(e)(9)(B). The imposition of requirements on the transferee's jurisdiction are intended to preserve a counterparty's termination and netting rights where the transferee fails to perform.

¹²¹ 12 USC § 1821(e)(11).

industries for such contract claims.¹²² Any claims by LCH for damages arising from repudiation would be subject to the claims process and distribution priority scheme set out in the FDIA, pursuant to which the FDIC, as receiver, determines claims that are timely filed and may disallow any claims which are not “proved to the satisfaction” of the FDIC.¹²³ Determinations by the FDIC are subject to administrative or judicial review.¹²⁴

As such, the QFC provisions under the FDIA would not protect or permit LCH’s rights under the Default Provisions where the triggering Event of Default relates solely to the conservatorship or financial condition (including insolvency) of a Relevant Clearing Member that is an Insured Institution. In the case of other Events of Default (*e.g.*, a payment or mark-to-market default), LCH would be able to exercise such rights, provided that the FDIC as conservator had not previously transferred all QFCs between LCH and such Insured Institution and its affiliates to another financial institution that is also a Clearing Member.

FDIC Receivership

The QFC provisions of the FDIA, in the context of an FDIC receivership of an Insured Institution, protect a counterparty’s ability to terminate, liquidate, net and exercise rights against collateral in connection with a QFC.

Section 1821(e)(8)(A) of the FDIA provides that:

Subject to paragraphs (9) and (10) of this subsection [1821(e)] and notwithstanding any other provision of this chapter (other than subsection (d)(9) of this section and section 1823(e) of this title), any other [U.S.] Federal law, or the law of any State, no person shall be stayed or prohibited from exercising—

- (i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with an insured depository institution which arises upon the appointment of the [FDIC] as receiver for such institution at any time after such appointment;
- (ii) any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause (i);
- (iii) any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts and agreements described in clause (i), including any master agreement for such contracts or agreements.¹²⁵

¹²² *Id.* § 1821(e)(3).

¹²³ *See* 12 USC § 1821(d)(3)-(5).

¹²⁴ *See* 12 USC § 1821(d)(6).

¹²⁵ 12 USC § 1821(e)(8)(A).

In the receivership context, therefore, QFCs are subject to the same requirements applicable to QFCs in the conservatorship context. QFCs are also subject to potential transfer by the FDIC, as receiver, to a solvent financial institution, but with restrictions different from those applicable in the context of a conservatorship. In the context of an FDIC receivership, a counterparty is stayed from exercising any rights under Section 1821(e)(8)(A) of the FDIA arising solely by reason of or incidental to the appointment of a receiver for the Insured Institution from the time of the appointment of a receiver to the earlier of: (1) the receipt of notice that all of the counterparty's and the counterparty's affiliates' QFCs with the Insured Institution have been transferred to a solvent institution; and (2) 5:00 p.m. (Eastern time) on the business day following the date of the receiver's appointment.¹²⁶ In other respects, the conditions surrounding the transfer of QFCs and the institutions to which QFCs may be transferred are identical to those discussed above in the context of an FDIC conservatorship. However, if the receiver does not transfer the counterparty's QFCs by 5:00 p.m. (Eastern time), the counterparty is free to exercise its rights under Section 1821(e)(8)(A) of the FDIA, subject to the receiver's rights of repudiation.

The FDIC is entitled to repudiate the QFCs of an Insured Institution for which it acts as receiver. However, as with the transfer of QFCs, if the FDIC repudiates any of the Insured Institution's QFCs with a given counterparty, all of the Insured Institution's QFCs with that counterparty and that counterparty's affiliates must be repudiated.¹²⁷ The FDIC's liability with respect to repudiated contracts is generally limited to actual direct compensatory damages determined, in the case of a QFC, as of the date of disaffirmance or repudiation of such QFC. With respect to repudiated contracts that are QFCs, such compensatory damages are expressly deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract claims.¹²⁸

As such, subject to the above constraints, the protections for QFCs would allow LCH, upon the appointment of the FDIC as receiver, to exercise its rights under the Rulebook and the Default Rules, including its rights under the Default Provisions.

Enforceability of the Default Provisions in a Bankruptcy Case of a Non-Bank SD

A Non-Bank SD Clearing Member is not subject to a bespoke insolvency regime similar to that for an FCM Clearing Member, a BD Clearing Member or an Insured Institution.¹²⁹ Instead, the insolvency of a Non-Bank SD Clearing Member will be subject to the general provisions of the

¹²⁶ 12 USC § 1821(e)(10)(B). Although we do not believe the statutory language of 12 USC § 1821(e)(10)(B) was intended to restrict the exercise of contractual remedies based on Events of Default other than those related to the appointment of the FDIC as receiver and other insolvency events, such as failure to make a payment when due or failure to post required margin, during the one-day period, there is some ambiguity as to whether 12 USC § 1821(e)(8)(G)(ii), which provides for the ability of the non-defaulting party to suspend its obligations to the failed Insured Institution during the one-day period, also suspends the defaulting party's obligations. We understand that the FDIC may take the position that the defaulting Insured Institution's contractual obligations are also suspended. We therefore express no opinion as to whether LCH may exercise remedies based on an Event of Default occurring during the one-day stay.

¹²⁷ *Id.* § 1821(e)(11).

¹²⁸ *Id.* § 1821(e)(3).

¹²⁹ As a result, for example, in contrast to the authority of a SIPA trustee in a proceeding commenced against a BD Clearing Member, the trustee in a Non-Bank SD Clearing Member insolvency would have no statutory authority to seek a temporary stay with respect to the liquidation of securities collateral.

Code. Nevertheless, for purposes of this Memorandum, the provisions of the Code referred to above in respect of the treatment of swaps (*i.e.*, FCM SwapClear Contracts and FCM ForexClear Contracts) will also be applicable in respect of the SwapClear Contracts and ForexClear Contracts entered into by an insolvent Non-Bank SD Clearing Member.

In particular, for the reasons referred to above, under Sections 362(b)(17) and 560 of the Code, LCH should be permitted to enforce its rights under the Rulebook and the Default Rules, including its rights under the Default Provisions to deal in, and to set off or net any termination or payment amounts owed in relation to, SwapClear Contracts and ForexClear Contracts entered into between it and the insolvent Non-Bank SD Clearing Member on the basis that such SwapClear Contracts and ForexClear Contracts as “swap agreements” and LCH and the Non-Bank SD Clearing Member are both “swap participants”. In addition, the protections described above that are available to LCH under the Code as a “master netting agreement participant” in respect of a “master netting agreement” should apply equally in respect of the SwapClear Contracts and ForexClear Contracts of an insolvent Non-Bank SD Clearing Member.

Enforceability of the Netting Provisions in a Proceeding under the OLA

If a Relevant Clearing Member was determined to be in default or in danger of default under Section 203 of the Dodd-Frank Act, it could be subject to liquidation under the OLA provisions of Title II of the Dodd-Frank Act, pursuant to which the FDIC would be appointed as its receiver.

OLA applies to a “systemically significant” financial company if the U.S. Secretary of the Treasury, in consultation with the U.S. President, determines that the company is in default or in danger of default, its failure would adversely affect the financial stability of the United States, no “viable private sector alternative” exists for preventing the default of the company, the effect of OLA’s provisions on creditors, counterparties and shareholders of the financial company is appropriate under the circumstances, and the application of OLA would mitigate potential adverse effects of the failure of the company.¹³⁰ Upon such a determination, the Relevant Clearing Member would be a “covered financial company” for the purposes of OLA.¹³¹

For the purposes of clarity, only a “financial company” is subject to the OLA. “Financial company” is defined as a company organized under any provision of U.S. federal law or of any U.S. state and that is: (1) a bank holding company; (2) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (3) a company that is predominantly engaged in activities that the Board of Governors of the Federal Reserve System has determined are financial in nature; or (4) any subsidiary of the foregoing that is predominantly engaged in activities that the Board of Governors of the Federal Reserve System has determined are financial in nature, but excluding insured depository institutions or insurance companies.¹³²

The provisions of OLA are modelled on those of the FDIA, and, as with the FDIA, certain generally applicable provisions of OLA impair the ability of creditors to exercise their contractual rights

¹³⁰ Dodd-Frank Act § 203.

¹³¹ *See id.* § 201(a)(8). Once a “financial company” is determined to be a “covered financial company”, the provisions of OLA, rather than the appropriate Statutory Regime discussed above, will govern the liquidation of the “covered financial company”.

¹³² *Id.* § 201(a)(11).

against a company in receivership. However, as also under the FDIA, in the case of QFCs, OLA provides certain protections to creditors in respect of QFCs. The term QFC is defined nearly identically in the FDIA and under OLA and therefore, for the reasons discussed above, the Relevant Contracts addressed in this Memorandum as well as the Rulebook should be QFCs for purposes of OLA. As discussed below, the rights of the FDIC as receiver are limited in respect of QFCs, although it may elect to transfer all of a counterparty's QFCs from the company in receivership to another solvent company.

Under OLA, the FDIC is appointed as receiver of the covered financial company and has a number of powers that may impair creditors' rights.

First, OLA, like the Code and the FDIA, limits the exercise of rights based on *ipso facto* provisions. Under Section 210(c)(13)(A) of the Dodd-Frank Act, the FDIC as receiver may enforce contracts "notwithstanding any provision of the contract providing for termination, default, acceleration, or the exercise of rights upon, or solely by reason of" the insolvency or orderly liquidation of the covered financial company. An attempt to exercise the right to terminate, to the extent based on a Relevant Clearing Member's insolvency, would likely be prohibited absent applicable exceptions for QFCs.¹³³

Second, while OLA does not impose an indefinite automatic stay on the exercise of contractual rights, Section 210(c)(13)(C) of the Dodd-Frank Act provides that a counterparty may not "exercise any right or power to terminate, accelerate, or declare an event of default under any contract to which the covered financial company is a party . . . or affect any contractual rights of the covered financial company, without the consent of the [FDIC] as receiver during the 90 day period beginning from the appointment of the [FDIC] as receiver". If this provision of OLA were to apply, it would potentially prohibit LCH from exercising its rights under the Default Provisions. However, as noted above, the Rulebook – and by extension, the Default Provisions – should be a QFC for purpose of OLA, and we analyze it in that context below.¹³⁴

The FDIC's powers as receiver under OLA are limited in several respects by provisions relating to QFCs.¹³⁵ Section 210(c)(8)(A) of the Dodd-Frank Act states:

Subject to subsection (a)(8) and paragraphs (9) and (10) of this subsection, and notwithstanding any other provision of this section, any other provision of [U.S.] Federal law, or the law of any [U.S.] State, no person shall be stayed or prohibited from exercising—(i) any right that such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a covered financial company which arises upon the appointment of the [FDIC] as receiver for such covered financial company or at any time after such appointment; (ii) any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause (i); or (iii) any right to

¹³³ Even QFCs, however, are subject to OLA's prohibition on walkaway clauses. See Dodd-Frank Act § 210(c)(8)(F). Modelled on the walkaway provision found in the FDIA, the provision in OLA would have the same effect on a walkaway clause as that found in the FDIA and applicable in an FDIA receivership.

¹³⁴ See also the discussion of FDIA proceedings in respect of Insured Institutions, *supra*.

¹³⁵ *Id.* § 210(c)(8).

offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts or agreements described in clause (i), including any master agreement for such contracts or agreements.¹³⁶

Section 210(a)(8) of the Dodd-Frank Act permits the FDIC, after its appointment as receiver of a covered financial company, to request a 90-day stay of judicial actions involving the covered financial company. While such a stay would impair LCH's ability to pursue legal action against a Relevant Clearing Member in the event of its liquidation under OLA, the stay would not affect LCH's ability to exercise its contractual rights under the Rulebook, including the Default Provisions.

Pursuant to Sections 210(c)(9) and 210(c)(10) of the Dodd-Frank Act, the FDIC, in a process modelled after that found in the FDIA, may transfer all QFCs between a counterparty and its affiliates and the failed institution to another financial institution and notify the counterparty of the transfer to another financial institution within one business day after the date of its appointment as receiver.¹³⁷ During this one-day period, a counterparty may not exercise any of its termination, liquidation or netting rights under the QFC solely by reason of or incidental to the appointment of the FDIC as receiver for the affected Relevant Clearing Member or by reason of the insolvency or financial condition of the Relevant Clearing Member for which the FDIC is appointed receiver.¹³⁸

If the FDIC elects to transfer a counterparty's QFCs with the covered financial company, the provisions of OLA constrain its ability to make selective transfers. It must transfer either all or none of the QFCs between the covered financial company and the counterparty and the counterparty's affiliates, as well as all unsubordinated claims of the counterparty and its affiliates against the covered financial company, all claims of the covered financial company against the counterparty and its affiliates, and all property securing or any other credit enhancement for any foregoing.¹³⁹ In addition, if the receiver elects to make these transfers, they must all be made to the same financial institution, which financial institution must be solvent and not subject to any bankruptcy, conservatorship or receivership (except to the extent the financial institution is a bridge institution related to the covered financial company).¹⁴⁰ In the case of a transfer of QFCs to a foreign financial institution or a branch or agency of a foreign institution, transfers are permitted

¹³⁶ *Id.* § 210(c)(8)(A).

¹³⁷ *Id.* § 210(c)(9)(A). The FDIC must notify the counterparty to the QFC of the transfer by no later than 5:00 p.m. on the business day following the day on which the FDIC is appointed as receiver. *Id.* § 210(c)(10)(ii). The FDIC must transfer all the QFCs between the failed institution and the counterparty and its affiliates. This requirement is designed to preserve cross-collateralization and netting rights with respect to the transferred QFCs.

¹³⁸ *Id.* § 210(c)(10)(B). Although we do not believe the statutory language of Section 210(c)(10)(B) of the Dodd-Frank Act was intended to restrict LCH from exercising its contractual remedies based on Events of Default other than those related to the appointment of the FDIC as receiver and other insolvency events, such as failure to make a payment when due or failure to post required margin, during the one-day period, there is some ambiguity as to whether Section 210(c)(8)(F), which provides for the ability of the non-defaulting party to suspend its obligations to the covered financial company during the one-day period, also suspends the defaulting party's obligations. We understand that the FDIC may take the position that the covered financial company's contractual obligations are also suspended. We therefore express no view as to whether LCH may exercise remedies based on an Event of Default occurring during the one-day stay.

¹³⁹ *Id.* § 210(c)(9)(A).

¹⁴⁰ *Id.* § 210(c)(9)(A) & (10)(C).

only if provisions related to the close-out and netting of the QFCs “are enforceable substantially to the same extent as permitted under [OLA]”.¹⁴¹

In addition, parallel to the provisions of the FDIA, OLA permits the FDIC as receiver to repudiate a covered financial company’s QFCs. As under the FDIA, the FDIC must repudiate all or none of the QFCs between the covered financial company and the counterparty and the counterparty’s affiliates.¹⁴² The counterparty’s damages are limited to actual direct compensatory damages,¹⁴³ which in the case of QFCs are deemed to include the normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims.¹⁴⁴ With respect to QFCs, damages are measured as of the date of repudiation or disaffirmance of such QFC.¹⁴⁵

If, on the other hand, the FDIC has not exercised its right to repudiate and the FDIC has not notified the counterparty of a transfer by 5:00 p.m. Eastern time on the business day following the date of the FDIC’s appointment as receiver, the counterparty would be entitled, notwithstanding any other provision of U.S. federal or state law, to exercise its right to terminate, liquidate or accelerate the QFC, to exercise any right under any security agreement or arrangement or other credit enhancement related to one or more QFCs and to “offset or net out any termination value, payment amount, or other transfer obligation arising under one or more QFCs, including any master agreement for such contracts or agreements”.¹⁴⁶

Thus, in the context of the Rulebook, which for these purposes is a QFC, LCH would be unable to exercise its rights under the Default Provisions on the sole basis of an Event of Default triggered by a Relevant Clearing Member’s receivership or financial condition under OLA because of the one-business-day stay applicable to QFCs. If the FDIC were to transfer all of the Relevant Clearing Member’s QFCs before the end of the one-business-day stay, LCH would be unable to exercise its rights under the Default Provisions. In such a case, LCH would be able to look to the transferee for performance. On the other hand, if the FDIC did not transfer the QFCs, LCH would be able to exercise such rights based on the protections afforded QFCs under OLA, subject to the FDIC’s repudiation rights.

5.2.4 Is there a “suspect period” prior to Insolvency Proceedings and/or Reorganization Measures where Contracts with a Relevant Clearing Member could be avoided or challenged and, if so, what are the grounds? What are the risks for LCH in entering into Contracts and in taking collateral in respect of those Contracts during such a period? Are any special protections or exemptions for the relevant arrangements, from avoidance or

¹⁴¹ *Id.* § 210(c)(9)(B). The imposition of requirements on the transferee’s jurisdiction are intended to preserve a counterparty’s termination and netting rights where the transferee fails to perform.

¹⁴² *Id.* § 210(c)(11).

¹⁴³ *Id.* § 210(c)(3)(A)(i).

¹⁴⁴ *Id.* § 210(c)(3)(C)(i).

¹⁴⁵ *Id.* § 210(c)(3)(A)(ii).

¹⁴⁶ *Id.* § 210(c)(8)(A).

challenge, available under the law of the Relevant Jurisdiction in respect of contracts in financial markets?

As a general matter, under the Statutory Regimes, certain transfers of property by the insolvent Relevant Clearing Member within a specified time period can be avoided and recovered from the recipient of such property. However, the Statutory Regimes also provide a set of special protections ensuring that any transfers in respect of Relevant Contracts made by a Relevant Clearing Member are exempt from avoidance in an insolvency proceeding, provided that the relevant transfer was not made with the actual intent to hinder, delay, or defraud creditors. Accordingly, in the absence of such actual intent, there should be no risks for LCH in entering into Relevant Contracts and in taking collateral in respect of such Relevant Contracts at any time.

5.2.5 Is there relevant netting legislation in the Relevant Jurisdiction that, in the context of Insolvency Proceedings or Reorganization Measures in respect of a Relevant Clearing Member, might apply as an alternative to the relevant arrangements set out in the Default Rules?

If for any reason the provisions of the Code or FDIA set out above were determined by a U.S. court not to be available, or in the event of a non-insolvency-related default, LCH's rights under the Default Rules may nevertheless be enforceable under FDICIA.

FDICIA provides for the enforceability of the termination, liquidation, acceleration and netting of payment obligations set out in any "netting contract" entered into between two "financial institutions", "notwithstanding any other provision of State or Federal law", including in non-insolvency situations, provided such netting contract is entered into between: (1) two "financial institutions"; or (2) two "members" of a "clearing organization".¹⁴⁷

Option 1: "Financial Institutions" and "Netting Contracts"

FDICIA protects the netting of payments in a "netting contract" entered into between two "financial institutions".

Financial Institutions

To qualify as a "financial institution", a party must either be: (i) an SEC-registered BD; (ii) a depository institution; (iii) a CFTC-registered FCM; or (iv) any other entity as designated by the Federal Reserve.¹⁴⁸ BD Clearing Members should qualify pursuant to (i) of this definition; Bank Clearing Members should qualify pursuant to (ii) of this definition; and FCM Clearing Members should qualify pursuant to (iii). Therefore, LCH and Non-Bank SD Clearing Members must qualify under (iv) of the definition. In that regard, the Federal Reserve has adopted Regulation EE, which provides that any entity (including a non-U.S. entity) that meets a two-prong test will be considered a "financial institution" for purposes of FDICIA.¹⁴⁹

¹⁴⁷ 12 USC §§ 4403(a), 4404(a). Several provisions of U.S. federal law are carved out of this general rule. *Id.*

¹⁴⁸ *Id.* at 4402(9).

¹⁴⁹ 12 CFR 231.1 et seq. The Federal Reserve has proposed expanding the scope of Regulation EE to include additional institutions, including CFTC-registered swap dealers, that may qualify as "financial institutions". See Netting Eligibility for

The first prong of this test requires a person to “represent” – which need not be in writing – that it will act as a counterparty to financial contracts “on both sides of the market”.¹⁵⁰ In providing the Relevant Clearing Services, LCH acts as central counterparty – as buyer to every seller, and seller to every buyer – which should qualify for the first prong of the test. Similarly, a Non-Bank SD Clearing Member actively undertakes swap dealing activities, which inherently involve, as dealer, a willingness to act as buyer and seller of financial contracts.

The second prong requires LCH and each Non-Bank SD Clearing Members to have exceeded one of the following quantitative thresholds within the previous 15 months: (i) at least \$1,000,000,000 in total gross notional outstanding of “financial contracts”¹⁵¹ with counterparties that are not affiliates; or (ii) gross mark-to-market positions of not less than \$100,000,000 (aggregated across all counterparties that are not affiliates) in one or more such financial contracts. As noted above, as of April 14, 2020, the total gross notional amount of cleared interest rate swaps for one subset (client clearing) of one of LCH’s clearing services (SwapClear) was just under \$1.3 quadrillion, with total gross notional outstanding in such contracts just under \$67 trillion and we are therefore of the view that LCH has therefore met the relevant thresholds to qualify as a “financial institution” for these purposes. In addition, a Non-Bank SD Clearing Member must, in order to be subject to SD registration, exceed the *de minimis* threshold of swap dealing activities, which is currently set at \$8,000,000,000 in a rolling 12-month period.¹⁵² Accordingly, every Non-Bank SD Clearing Member must necessarily, by becoming subject to swap dealer registration, exceed the first threshold of being a “financial institution” under Federal Reserve Regulation EE.¹⁵³

“Netting Contract”

To be a “netting contract”, an agreement must provide for “netting present or future payment obligations or payment entitlements (including liquidation or close-out values relating to the obligations or entitlements) among the parties to the agreement”. The Default Rules provide that LCH may take a number of different actions to exercise its rights in the event of a Relevant Clearing Member default, including the power to liquidate positions and net payment obligations to determine one or more termination amounts. On this basis, we believe the Default Rules should qualify as a “netting contract” for purposes of FDICIA.¹⁵⁴

Financial Institutions, 84 Fed. Reg. 18741 (May 2, 2019). Therefore, if adopted as proposed, all Non-Bank SD Clearing Members would automatically qualify as “financial institutions” for purposes of FDICIA.

¹⁵⁰ *Id.* at 231.3(a).

¹⁵¹ “Financial contract” is defined in Federal Reserve Regulation EE by reference to the definition of QFC (“qualified financial contract”) under FDIA (*i.e.*, any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement and similar agreement designated by the FDIC, other than spot contracts).

¹⁵² We note that, as described in the main body of this Memorandum, the *de minimis* threshold for swap dealer registration is substantially lower for swap dealers engaging in swap dealing business with Special Entities. We are not aware of any Relevant Clearing Member that is a swap dealer registered solely on the basis of exceeding the *de minimis* threshold in respect of Special Entities.

¹⁵³ To the extent that either LCH or a Non-Bank SD Clearing Member ever fell below both thresholds, it would have a period of 15 months within which to exceed either threshold before it would no longer qualify as a “financial institution”.

¹⁵⁴ The contract must also not be precluded by U.S. federal law in order to qualify as a “netting contract”. 12 USC § 4403(a). We are not aware of any provision of U.S. federal law that would preclude the Default Rules or the LCH Agreements more generally.

Option 2: “Members” of a “Clearing Organization”

FDICIA protects the netting of payments in a “netting contract” entered into between “members” of a “clearing organization”. For the reasons set out above, we believe the Default Rules qualify as a “netting contract” for purposes of FDICIA.

“Members”

The term “member” refers to any member of or participant in a clearing organization, including the clearing organization itself.¹⁵⁵ Accordingly, the Relevant Clearing Members and LCH should also qualify as “members” for these purposes, provided that LCH also qualifies as a “clearing organization”.

“Clearing Organization”

The term “clearing organization” is defined to include a clearing organization that is, *inter alia*, a CFTC-registered DCO, a multilateral clearing organization (“MCO”)¹⁵⁶ and a clearing organization the members of which are all “financial institutions”.¹⁵⁷ In our view, this term should include LCH in respect of the Relevant Clearing Services that fall within the scope of its DCO registration, including the FCM SwapClear Service, FCM ForexClear Service and the FCM Listed Interest Rates Service provided to FCM Clearing Members.

In respect of all other Relevant Clearing Services, LCH can qualify as a “clearing organization” to the extent that all of its members meet the quantitative tests to qualify as “financial institutions” set out above. We also believe that LCH may be able to qualify as a “clearing organization” by analogizing its status to that of an MCO.¹⁵⁸ A non-U.S. clearing organization was able to qualify as a “multilateral clearing organization” to the extent that an applicable U.S. regulator (in this case, the CFTC) determined it was subject to appropriate regulation by the domestic regulator of its home jurisdiction. Accordingly, qualification was based on an assessment by a U.S. regulator of the local regulatory regime of the non-U.S. clearing organization.

LCH is registered with the CFTC as a DCO.¹⁵⁹ To register, LCH was required to demonstrate compliance with various “DCO Core Principles”, including “Core Principle R” in respect of legal risk.¹⁶⁰ The CFTC Rules implementing Core Principle R require a non-U.S. applicant to show that it operates pursuant to a well-founded, transparent and enforceable domestic legal framework covering each aspect of the applicant’s DCO activities and that it has addressed any potential

¹⁵⁵ 12 USC § 4402(11).

¹⁵⁶ The term MCO refers to a clearing organization permitted under FDICIA to clear over-the-counter derivatives. To qualify as an MCO, an entity was required to be: (i) a U.S. federal or state bank; (ii) an SEC-registered clearing agency; (iii) a CFTC-registered DCO; or (iv) a foreign entity subject to appropriate regulation in its home jurisdiction.

¹⁵⁷ 12 USC § 4402(2).

¹⁵⁸ The Dodd-Frank Act provided that any U.S. depository institution clearing swaps as an MCO prior to the enactment of the Dodd-Frank Act was automatically deemed to be registered with the CFTC as a DCO. *See* Section 725(b) of the Dodd-Frank Act. Despite the *de facto* abolition of the MCO category under the CEA, the reference was not removed from FDICIA.

¹⁵⁹ *See* note 30, *supra*.

¹⁶⁰ *See* Section 5b(c)(2)(R) of the CEA.

conflicts of law issues.¹⁶¹ The CFTC has similarly issued a number of orders and determinations in which it has found the regulatory regime in the United Kingdom to be substantially equivalent to the CEA and CFTC Rules applicable to U.S. participants in the derivatives markets.¹⁶²

Therefore, as a registered DCO located in the United Kingdom, LCH has been subject to an assessment of its domestic legal and regulatory regime that is substantively equivalent to the assessment that would have been made had LCH applied for MCO status. On that basis, LCH meets or exceeds the qualifications applicable to MCOs and should therefore fall within the intended scope of the term “clearing organization” in FDICIA for all Relevant Clearing Services not covered by the scope of its DCO registration order.

FDICIA Summary

For the reasons set out above, LCH and Relevant Clearing Members should qualify as “members” of a “clearing organization” and the Default Rules should be a “netting contract”.¹⁶³ We also believe that LCH and Relevant Clearing Members should qualify as “financial institutions”. LCH should therefore have two sources of protection under FDICIA to enforce its rights under the Default Rules to liquidate positions, net payment flows and determine relevant termination amount(s) upon the occurrence of an insolvency or non-insolvency-related Event of Default in respect of a Relevant Clearing Member.

5.2.6 Can a claim for a close-out amount be proved for in Insolvency Proceedings without conversion into the local currency?

Under the Code, SIPA, the FDIA, and OLA, any claim must be converted to United States Dollars at the exchange rate prevailing on the date of the commencement of the insolvency proceeding.

5.3 Position Transfers

5.3.1 Following the commencement of an Insolvency Proceeding applicable to an FCM Clearing Member, what are the duties of the trustee for such FCM Clearing Member with regard to transferring positions and associated margin from the defaulting FCM Clearing Member to a solvent FCM Clearing Member?

The Statutory Regime applicable to an insolvent FCM Clearing Member provides for a two-step transfer and liquidation process for the treatment of customer funds and assets, which is described

¹⁶¹ See CFTC Rule 39.27.

¹⁶² See, e.g., Foreign Futures and Options Transactions, 68 Fed. Reg. 58583 (October 10, 2003) (determining that the UK had established a comparable regulatory program for futures contracts to that of the CFTC within the meaning of Appendix A of Part 30 to the CFTC Regulations). The UK has also benefited from a number of comparability determinations adopted by the CFTC in respect of the EU’s regulatory regime for swaps. See Comparability Determination for the European Union: Certain Entity-Level Requirements, 78 Fed. Reg. 78923 (December 27, 2013); Comparability Determination for the European Union: Certain Transaction-Level Requirements, 78 Fed. Reg. 78878 (December 27, 2013); Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps, 82 Fed. Reg. 48394 (October 18, 2017); and In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities Authorized Within the European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities (December 8, 2017).

¹⁶³ FCM Regulation 37(f) (*Interpretation in Relation to FDICIA*) provides additional support for this conclusion by expressly reflecting the intent of LCH and FCM Clearing Members for the FCM Rulebook to qualify as such.

in more detail below.¹⁶⁴ Importantly, these requirements apply only in respect of the “customers”¹⁶⁵ of an insolvent FCM Clearing Member and their “customer property”.¹⁶⁶

In the first instance, the trustee is instructed to “use its best efforts to effect a transfer” of customer positions and to notify the CFTC as soon as possible “but in no event later than the close of business on the third calendar day after” the FCM Clearing Member has filed for bankruptcy whether it intends to transfer the positions.¹⁶⁷ Where the trustee is not able to effect the transfer of all customer positions, the trustee is directed to liquidate all open commodity contracts “promptly and in an orderly manner”.¹⁶⁸

Transfers

As noted above, the trustee of an insolvent FCM Clearing Member is required to use its best efforts to transfer the open commodity contracts, and related equity, held for or on behalf of its customers. Bulk as well as partial transfers are possible, subject to certain limitations on transfers of customer assets as well as certain requirements to ensure protection from avoidance under the Code.

Customer accounts are generally eligible for transfer provided they are not in deficit.¹⁶⁹ There are, however, limits on the amount of equity that may be transferred alongside the customer accounts. Specifically, no amounts may be transferred that would exceed the “funded balance” of the account, calculated as of the previous calendar day less the value of any property previously returned or transferred on behalf of the account.¹⁷⁰ Following a bulk transfer, a customer whose open

¹⁶⁴ Please note that the discussion in this section 5.3 is necessarily of a general nature only, and does not constitute a detailed application of the Code and the CFTC’s Part 190 Rules to a specific set of facts or in respect of the insolvency of a specific FCM Clearing Member, nor is intended to serve as an exhaustive treatment of all aspects of the CFTC’s Part 190 Rules.

¹⁶⁵ A “customer” includes any person that is: (i) an entity for or with whom the FCM Clearing Member deals and holds a claim against such FCM Clearing Member on account of a commodity contract made, received, acquired or held by or through the FCM Clearing Member in the ordinary course of the FCM Clearing Member’s business as an FCM from or for the account of such entity; (ii) an entity that holds a claim against an FCM Clearing Member arising out of: (I) the making, liquidation or change in value of a commodity contract specified in clause (i); (II) a deposit or payment of cash, a security or other property with an FCM for the purpose of making or margining such a commodity contract; or (III) the making or taking of delivery on such a commodity contract. See 11 USC § 761(9).

¹⁶⁶ “Customer property” is broadly defined to include “cash, a security, or other property, or proceeds of such cash, security or property, received, acquired, or held by or for the account of the [insolvent FCM Clearing Member], from or for the account of a customer”. See 11 USC § 761(10). The term also includes customer property that should have been, but was not, segregated or that was unlawfully converted but that is part of the insolvent FCM’s estate. See generally CFTC Rule 190.08(a)(1). In addition, to the extent that the trustee is able to use its powers to avoid fraudulent, preferential or other transfers under the Code, and the avoided transfer involved property that, but for the avoided transfer, would have qualified as customer property, such recovered property will form part of the pool for distribution. See 11 USC § 764(a).

¹⁶⁷ See CFTC Rules 190.02(a)(2), (e). Any such transfer must be completed no later than seven calendar days following the FCM Clearing Member’s insolvency filing.

¹⁶⁸ See CFTC Rule 190.02(f).

¹⁶⁹ See CFTC Rule 190.06(e)(1). The insolvent FCM Clearing Member’s house accounts as well as certain other accounts (leverage transaction accounts and dealer option accounts) not relevant to this analysis are similarly ineligible for transfer. *Id.*

¹⁷⁰ See CFTC Rule 190.06(e)(2). The trustee is required to determine the “funded balance” for each customer account (calculated in accordance with CFTC Rule 190.07(c)) as of the close of business each day no later than noon on the following business day. See CFTC Rule 190.04(b).

commodity contracts have been transferred may be required to post additional margin to the transferee, failing which such contracts may be liquidated.¹⁷¹

A trustee may also effect two types of partial transfers.¹⁷² In the first case, where all of a particular customer's open commodity contracts cannot be transferred, the trustee may liquidate a portion of the portfolio to generate a sufficient amount of equity to facilitate the transfer of the unliquidated portion of the portfolio.¹⁷³ Alternatively, the trustee may transfer some, but not all, of the customer accounts of the insolvent FCM Clearing Member.¹⁷⁴ The CFTC may not refuse any such partial transfer "solely on" the basis that it would prefer the transfer of accounts the liquidation of which could adversely affect the market or the estate of the insolvent FCM Clearing Member.

Notwithstanding any of the foregoing requirements, the CFTC is empowered to prohibit, or permit, any transfers "in appropriate cases and to protect the public interest".¹⁷⁵ In addition, the trustee is permitted to ask the CFTC for an exemption from any time limit set in the Part 190 Rules that is not otherwise mandated by the Code.¹⁷⁶ Finally, transfers are not permissible where the transferee FCM would fail to satisfy the CFTC's minimum financial requirements as a result of the transfer.¹⁷⁷

Provided the transfers effected by the trustee meet certain requirements, such transfers may not be avoided under the Code. Principally, any transfer of open commodity contracts and related margin of an insolvent FCM Clearing Member's customers, or the liquidation of any such commodity contracts, may not be avoided if the transfer is approved by the CFTC and is made within seven days of the insolvency filing.¹⁷⁸ In addition, following an insolvency filing, no transfer may be avoided under the Code to the extent that the transfer is made on or before the seventh calendar day following the insolvency filing and either: (i) is made by the trustee or the insolvent FCM Clearing Member's self-regulatory organization following proper prior notice to the CFTC¹⁷⁹ and the CFTC has not objected to the transfer; or (ii) occurs at the CFTC's direction and is effected in accordance with such terms and conditions as may be set by the CFTC.

¹⁷¹ The transferee is permitted to accept the transfer of a customer's open commodity contracts that are undermargined subject to any loss due to the failure to recover such deficit from the customer. The transferee is also required to keep any such transferred contract open for one business day after receipt, unless the customer fails "within a reasonable amount of time" to meet a margin call for the difference. See CFTC Rule 190.06(c)(2)-(3).

¹⁷² See CFTC Rule 190.06(f)(3).

¹⁷³ Note that, for any open commodity contract that is part of a spread or a straddle, then both sides of such spread or straddle must be transferred or both must be liquidated. *Id.*

¹⁷⁴ Special rules apply to transfers of dealer option contracts. *Id.*

¹⁷⁵ See CFTC Rule 190.06(h).

¹⁷⁶ See CFTC Rule 190.10(b).

¹⁷⁷ See CFTC Rule 190.06(c)(1).

¹⁷⁸ See 11 USC § 764(b).

¹⁷⁹ Notice must be made to the CFTC as soon as possible but not later than the close of business on the third calendar day after the insolvency filing. See note 167 and accompanying text, *supra*.

Liquidation

To the extent that the trustee is unable to make the transfers described above, the trustee is directed to “distribute customer property ratably to customers on the basis of and to the extent of such customers’ allowed net equity claims, and in priority to all other claims”.¹⁸⁰ The insolvent FCM Clearing Member’s “public customers” are given priority in respect of such distributions before all other claims (other than certain administrative expenses), including the claims of the insolvent FCM Clearing Member’s “non-public customers”.¹⁸¹

All distributions must be made ratably on a so-called “account class” basis.¹⁸² The trustee is responsible for marshaling separate pools of customer property for each account class, starting with the items of customer property recorded on the books and records of the insolvent FCM Clearing Member and including all customer property that is “readily traceable” to the account class.¹⁸³ Once the customer property pool is established for a given account class, the trustee is then required to distribute such property to customers in that account class to the extent of their allowed net equity.

For purposes of distribution, a customer that holds multiple account classes with the insolvent FCM Clearing Member will have separate net equity determinations for each account class.¹⁸⁴ A customer’s allowed net equity claim in respect of an account class is equal to such customer’s funded balances in relation to that account class, adjusted upwards or downwards based on certain post-insolvency events.¹⁸⁵ The net equity calculation is based on the valuation of customer property as of the date of its return or transfer.¹⁸⁶ Accordingly, the precise value of a customer’s allowed net equity will fluctuate over time due to intervening market moves.

Notably, a customer can set off a negative equity balance in one account class against a positive equity balance in another account class; otherwise, the net equity of one customer cannot be set off against the net equity of another customer. Where the customer property allocated to a given account class is insufficient to satisfy in full claims of all “public customers”, then the other

¹⁸⁰ 11 USC § 766(h).

¹⁸¹ A “non-public customer” includes any “customer” that is the holder of a “proprietary account”, which is generally defined to include affiliates, control persons and certain senior personnel of an FCM. *See* CFTC Rule 190.01(cc). A “public customer” is any “customer” that is not a “non-public customer”. *See* CFTC Rule 190.01(ii).

¹⁸² “Account class” treatment refers to the principle under the CFTC Rules providing that customer collateral received by an FCM Clearing Member to margin cleared swaps, U.S. futures and non-U.S. futures may not be commingled and the collateral in respect of one class must be held separately from the other classes. *See* CFTC Rule 190.01(a)(1); *see also* CFTC Rules 1.20(e), 22.2(c), and 30.7(e). Notwithstanding the foregoing, the CFTC may permit commingling across account classes by rule, regulation or order, for example in connection with a portfolio margining program.

¹⁸³ *See* CFTC Rule 190.08(c)(1) (“property held by or for the account of a customer, which is segregated on behalf of a specific account class, or readily traceable on the filing date to customers of such account class, must be allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable”). The full definition of customer property that is pooled for distribution is set out in CFTC Rule 190.08(a).

¹⁸⁴ *See* CFTC Rule 190.07(a).

¹⁸⁵ For full details of the multi-step process of calculating net equity, *see* CFTC Rule 190.07(b).

¹⁸⁶ *See* CFTC Rule 190.07(e).

property of the insolvent FCM Clearing Member may be added to the customer property pool to make up for any losses.¹⁸⁷

Specially Identified Property

Customers for whom an insolvent FCM Clearing Member holds specifically identifiable property (“SIP”) benefit from certain additional rights under the CFTC Rules. The term SIP covers several classes of property, including: (i) securities, warehouse receipts and other documents of title that margin, guarantee or secure an open commodity contract and which are held for the account of a customer, registered in that customer’s name, not transferable by delivery and not a short-term obligation; and (ii) hedged positions in open commodity contracts held for a customer’s account in a designated hedge account.¹⁸⁸

A customer’s principal additional right is the ability to instruct the trustee to return or transfer their SIP. A customer’s right to require the return or transfer of its SIP is limited to the value of the funded portion of the customer’s net equity claim against the customer pool for the relevant account class. The customer may nevertheless obtain the SIP in such circumstances by paying cash to cover the difference in the value of the SIP and the funded portion of its net equity claim.¹⁸⁹ Where the SIP is margining an open commodity contract, the customer must pay the full fair market value of the property, plus a “reasonable reserve” as determined in the trustee’s discretion.¹⁹⁰

Notwithstanding a customer’s exercise of its rights in respect of SIP, the customer remains subject to the overriding principle of the Code and the Part 190 Rules of *pro rata* distribution of assets to all customers in a given asset class. As a result, a customer that instructs the trustee to return or transfer SIP is generally required, as a condition to the return or transfer, to pay the estate of the insolvent FCM Clearing Member an amount determined by the trustee.

5.3.2 May LCH, as a registered DCO, facilitate and assist the trustee in such transfers?

The provisions of the Code and Part 190 of the CFTC Regulations clearly anticipate that the primary responsibility for transferring customer positions and liquidating open commodity contracts will fall to the trustee. For example, registered DCOs are expressly prohibited from adopting rules that would conflict with the provisions of, or interfere with transfers permitted under, Part 190.¹⁹¹

Nevertheless, the Part 190 Rules, when considered holistically, also appear to embed an unspoken expectation that key market participants, including registered DCOs, will cooperate with the trustee in fulfilling the trustee’s duties. The “Schedule of Trustees Duties” appended to the Part 190 Rules contains several statements anticipating ongoing contact and cooperation between the trustee and

¹⁸⁷ See CFTC Rule 190.08(a)(1)(ii)(J).

¹⁸⁸ See CFTC Rule 190.01(II).

¹⁸⁹ See CFTC Rule 190.08(d)(1)(ii).

¹⁹⁰ See CFTC Rule 190.08(d)(1)(i). The trustee may also require the customer to post adequate security to cover the potential for overpayments.

¹⁹¹ This prohibition extends to “other self-regulatory organizations”. See CFTC Rule 190.06(a).

registered DCOs.¹⁹² For example, the trustee is reminded of the obligation to notify registered DCOs of the insolvency filing, and to work with registered DCOs to effectuate transfers.¹⁹³ The trustee is also expected to attempt to forestall liquidation by a registered DCO of open commodity contracts that are available for transfer.¹⁹⁴ It would also seem that the trustee's daily calculation of a customer's net equity would be made more difficult in the absence of cooperation by registered DCOs, which would likely serve as a valuable source of information to corroborate the location and nature of customer collateral as well as the value of open commodity contracts.

It is our view, therefore, that LCH, as a registered DCO, should be prepared to work cooperatively and constructively with a trustee appointed in respect of an insolvent FCM Clearing Member. This general statement notwithstanding, we would note that nothing in the Part 190 Rules limits a DCO's contractual rights under its rules to liquidate open commodity contracts.¹⁹⁵

5.4 Settlement Finality

5.4.1 Would the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member affect the finality of settlement of a Payment Transfer Order, including the corresponding transfer of funds, from the Relevant Clearing Member to LCH through a Settlement Services Provider or PPS Bank (or both)? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.

The Code and the FDIA each prescribe certain limits on the avoidance powers that may otherwise be available in respect of Payment Transfer Orders.¹⁹⁶

The Code

The Code generally provides for the ability of the trustee to avoid certain pre-petition preferential and fraudulent transfers made by the debtor.¹⁹⁷ However, these avoidance powers are limited in respect of pre-petition transfers made by certain types of market participants in respect of certain classes of financial contracts.

Specifically, a trustee may not avoid any transfers made by or to, or for the benefit of: (1) a commodity broker or financial participant in respect of a commodity contract or securities contract; (2) a repo participant or financial participant in respect of a repurchase agreement; or (3) a swap participant or financial participant in respect of a swap agreement.¹⁹⁸ For the reasons set out in

¹⁹² See Appendix A: Form 1 – Operation of the Debtor's Estate – Schedule of Trustee's Duties to the Part 190 Rules (“**Schedule of Trustees Duties**”).

¹⁹³ See, e.g., Schedule of Trustees Duties, Date of Order for Relief, ¶¶ 1, 3.a.i.

¹⁹⁴ *Id.* at First Calendar Day After the Entry of Order for Relief, ¶ 3.

¹⁹⁵ See CFTC Rule 190.06(a)(3) (expressly stating that nothing in that rule limits the exercise of any contractual right of a registered DCO to liquidate open commodity contracts).

¹⁹⁶ As used herein, the term “**Payment Transfer Order**” has the meaning ascribed to it in clause 1.9 of LCH's Settlement Finality Regulations.

¹⁹⁷ 11 USC §§ 547, 548.

¹⁹⁸ *Id.* at § 546(e) (commodities contracts and securities contracts), (f) (repurchase agreements), and (g) (swap agreements).

section 5.2.3, *supra*, LCH should qualify as the relevant type of market participant for each of the foregoing classes of financial contracts, making these protections available in respect of all forms of Relevant Contracts addressed in this Memorandum.

A “transfer” for these purposes is defined to include, *inter alia*, “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with: (i) property; or (ii) an interest in property”.¹⁹⁹ The expansive nature of this definition is sufficient, in our view, to include all Payment Transfer Orders set out in the Settlement Finality Regulations. Therefore, the relevant provisions of Section 546 of the Code would prevent the trustee of an insolvent Relevant Clearing Member from avoiding any Payment Transfer Orders in respect of Relevant Contracts, except where there is an actual intent to hinder, delay or defraud.²⁰⁰

FCM Listed Interest Rates Contracts and RepoClear Contracts will also benefit from a further level of protection under Section 546(e) of the Code, which prevents a trustee from avoiding certain margin and settlement payments made by or to, or for the benefit of, a commodity broker or financial participant in respect of commodity contracts or securities contracts. The definitions of “margin payment” for securities contracts and commodity contracts are not identical but both are drafted broadly to include all payments or deposits of cash, securities or other property “commonly known to the trade” as original margin, maintenance margin or variation margin, as well as mark-to-market payments.²⁰¹ The term “margin payment” also includes, in respect of commodity contracts, settlement payments, variation payments, daily settlement payments, and final settlement payments made as adjustments to settlement prices, whereas for securities contracts there is a separately defined set of “settlement payments” that include “a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade”.²⁰²

In our view, the transfers forming part of the Payment Transfer Orders, including the corresponding transfer of funds, falls clearly within the scope of the foregoing definitions. These transfers are inextricably linked to the margining and risk management aspects of LCH’s clearing services, and are therefore “commonly known to the trade” as being in the nature of the margin and settlement payments that are intended to be covered by the protections of Section 546(e) of the Code.²⁰³

¹⁹⁹ 11 USC § 101(54)(D).

²⁰⁰ See 11 USC § 548(a)(1)(A). There is a narrow exception from this general rule where it can be shown that the relevant transfers were void under applicable law, *see In Re Enron Corp.*, 325 B.R. 671 (Bankr. S.D.N.Y. 2005) (holding that payments were avoidable under the Code as fraudulent transfers because such payments were illegal distributions and therefore void under applicable state law), however we are not aware of any circumstances that would cause any Payment Transfer Orders properly made through LCH’s settlement systems to be void under applicable law.

²⁰¹ 11 USC §§ 741(5), 761(15).

²⁰² *Id.* at § 741(8).

²⁰³ We note that there are examples where U.S. courts have declined to characterise a specific transfer as a “margin payment” or “settlement payment” for purposes of Section 546(e) of the Code. In each of these cases, however, the transaction of which the transfer formed a part contained unique or unusual features. *See, e.g., In Re Enron Creditors Recovery Corp.*, 407 B.R. 17 (Bankr. S.D.N.Y. 2009) (finding a triable question of fact whether certain payments for early redemption of commercial paper may be payments to retire a debt rather than a *bona fide* “settlement payment”); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 664 (N.D.Ill. 1991) (concluding that purchases of securities from shareholders in a leveraged buy-out transaction were not within scope of the § 546(e) exception because avoidance “poses no significant threat to those in the clearance and settlement chain”). By contrast, we are unaware of any case setting aside a transfer made as part of ordinary-course settlement procedures of a central

The FDIA

The FDIA provides a similarly wide set of protections against avoidance by the FDIC, whether acting as conservator or receiver of an insolvent Insured Institution, of any “transfers” of money or other property in connection with any QFC of that Insured Institution, notwithstanding any U.S. federal or state law to the contrary.²⁰⁴ For these purposes, a “transfer” includes “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the [Insured Institution’s] equity of redemption”.²⁰⁵ In our view, Payment Transfer Orders fall within the wide scope of the term “transfer”. Accordingly, as all Relevant Contracts are QFCs, then the FDIC, whether acting as conservator or receiver of an insolvent Insured Institution, would not have the authority to avoid any Payment Transfer Order made prior to the insolvency.

As under the Code, the foregoing exemption from the FDIC’s avoidance powers is not available in the event of transfers where the transferee had actual intent to hinder, delay or defraud the Insured Institution, the Insured Institution’s creditors, or the FDIC.²⁰⁶

5.4.2 Would the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member affect the finality of settlement of a Securities Transfer Order, including the corresponding transfer of securities, from the Relevant Clearing Member to LCH through a Securities System Operator? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.

The limits on the avoidance powers available under the Code and the FDIA discussed in section 5.3.1, *supra*, also apply in respect of Securities Transfer Orders.²⁰⁷ As discussed above, the Code and FDIA prevent avoidance of “transfers”, a term that is defined broadly to include all “direct or indirect” dispositions of “property” or interests in property.²⁰⁸ Accordingly, in our view the term “transfer” is sufficiently broad to include the transfers of securities contemplated in the definition of Securities Transfer Order. Moreover, qualifying transfers do not need to be direct, as the term expressly includes all “indirect” dispositions of securities as well; in our view, this is sufficient to

counterparty; in fact, the case law suggests that Section 546(e) was intended to protect “routine” forms of settlement payments such as those addressed in this Memorandum. *See, e.g., In re Kaiser Steel Corp*, 952 F.2d 1230, 1238 (10th Cir. 1991) (“No party. . . argues that a shareholder cannot make or receive a settlement payment. . . with respect to a ‘routine’ purchase of securities”); *Bevill Bresler Schulman Asset Management Corporation v. Spencer Savings & Loan Association*, 878 F.2d 742, 747 (“Congress was concerned about the volatile nature of the commodities and securities markets and decided that certain protections were necessary to prevent ‘the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market’”).

²⁰⁴ 12 USC § 1821(e)(8)(C)(i).

²⁰⁵ *Id.* at § 1821(e)(8)(D)(viii).

²⁰⁶ *Id.* at § 1821(e)(8)(C)(ii).

²⁰⁷ As used herein, the term “**Securities Transfer Order**” has the meaning ascribed to it in clause 1.13 of LCH’s Settlement Finality Regulations.

²⁰⁸ *See* notes 199 and 205, *supra*.

ensure that the use of a Securities System Operator to facilitate such transfers does not render the limitation on avoidance powers unavailable.²⁰⁹

Securities Transfer Orders made with an actual intent to hinder, delay or defraud would not benefit from these protections.

5.4.3 Are there any circumstances (such as the commencement of Reorganization Measures) which might give rise to a loss of finality protections before the commencement of Insolvency Proceedings? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.

As identified in the discussion in sections 5.3.1 and 5.3.2, *supra*, there are three narrow sets of circumstances in which the avoidance powers may not apply to a transfer: (1) where the transfer is effected with an actual intent to hinder, delay or defraud; (2) where the transfer is for any reason void under applicable law; and (3) where the court determines that the transfer is so tenuously related to “routine” settlement activities as to fall outside the legislative intent of limiting avoidance powers.

* * * * *

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²⁰⁹ We would also note in this regard the case law commentary on the scope of § 546(e) of the Code. *See* note 203 and accompanying text, *supra*. Despite the disagreement over the precise scope of the provision, there is unanimous agreement that the use of securities intermediaries, *i.e.*, indirect links in the chain of settlement (such as the use of a Securities System Operator), falls squarely within the available protections.