# MEMORANDUM OF LAW
# FOR THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. AND THE FUTURES INDUSTRY ASSOCIATION

Recognition of the U.S. Law Trusts under which Assets are Held and Enforceability of the Liquidation and Credit Support Provisions of Certain Futures Account Agreements and a Cleared Derivatives Addendum upon a Customer's Default or Insolvency

2 October 2020

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## 1 Introduction

1.1 This Memorandum of Law deals with the recognition of the U.S. Law trusts under which customer assets are held and the enforceability of the liquidation and credit support provisions of a Covered Base Agreement (as defined below) and two forms of the addendum for Cleared Derivatives Transactions published by the Futures Industry Association ("**FIA**") and ISDA, one published in 2012 and one published in 2018 (each a "**CDA**"), entered into by an entity that is registered with the United States Commodity Futures Trading Commission (the "**CFTC**") as a futures commission merchant ("**FCM**") and such FCM's Customer (as defined below), setting forth the right of such FCM, upon the occurrence of an event giving rise to any right of such FCM to liquidate all Cleared Derivatives Transactions (as defined below) under a Covered Base Agreement (as defined below), to liquidate such transactions and to determine amounts owing with respect thereto, to exercise remedies in respect of Cleared Derivatives Payment Rights (as defined below) and the proceeds thereof with respect to obligations arising from Cleared Derivatives Transactions and to apply Cleared Derivatives Credit Support (as defined below) transferred by a Customer in connection therewith in order to determine the aggregate net balance of account as between the FCM and the Customer.

1.2 We understand that each CDA will supplement a futures customer account agreement (each a "**Covered Base Agreement**" and together, "**Covered Base Agreements**") entered into by a FCM and such FCM's Customer.

1.3 This Memorandum of Law is given in relation to customers in the Cayman Islands (each a "**Customer**") in the form of:

1.3.1 a company, including any exempted, ordinary resident, ordinary non-resident and limited duration company (the "**Company**") incorporated under the Companies Law (2020 Revision) (the "**Companies Law**");

1.3.2 a branch established or located in the Cayman Islands of a company incorporated or organised outside the Cayman Islands;

1.3.3 a company incorporated in the Cayman Islands acting as trustee (the "**Trustee**") of a Cayman Islands law governed trust (the "**Trust**"); or

1.3.4 an exempted limited partnership (an "**Exempted Limited Partnership**") established under the Exempted Limited Partnership Law (2018 Revision) (the "**Exempted Limited Partnership Law**") or a limited partnership (together with an Exempted Limited Partnership, each a "**Partnership**"), established under the Partnership Law (2013 Revision) (the "**Partnership Law**"), each with one or more general partners (together and individually, the "**General Partner**").

1.4 Capitalized terms used in this Memorandum, which are not defined, have the meaning given to them in the CDA as the context requires.

1.5 This Memorandum addresses the efficacy and enforceability of a Covered Base Agreement and CDA without reference to any specific facts or circumstances. In view of this, the application of the principles set out in this Memorandum may vary depending upon the particular set of circumstances.

1.6 We have not made any independent examination of the laws of any jurisdiction other than the Cayman Islands or of the extent to which such laws may govern or affect the transactions contemplated by the CDA and we do not express or imply any views on any such laws in this Memorandum.

1.7 The views hereinafter expressed are given only as to circumstances existing on the date hereof and known to us and are limited to the laws of the Cayman Islands as in force on the date hereof.

1.8 References in this Memorandum to the insolvency of a Customer include:

1.8.1 in respect of a Trust, where the assets of the Trust are insufficient to meet liabilities incurred by the Trustee as trustee of the Trust; and

1.8.2 in respect of a Partnership, where the assets of the Partnership are insufficient to meet Partnership liabilities.

## 2 General Background Information

With respect to each Covered Base Agreement, we understand that:

2.1 the FCM agrees to carry one or more accounts on behalf of the Customer (each, an "**Account**") and to execute, carry and clear transactions for the purchase or sale of commodities for future delivery on, or subject to the rules of a derivatives clearing organization (a "**DCO**") registered as such under the United States Commodity Exchange Act (the "**CEA**") or traded on, or subject to the rules of, a board of trade outside the United States (such contracts executed on a contract market designated pursuant to Section 5 of the CEA and cleared by a U.S.-registered DCO, "**U.S. Futures**", such contracts traded on or subject to the rules of, a board of trade outside the United States, and options thereon, "**Foreign Futures**" and, collectively "**Futures**") and/or options on U.S. Futures subject to Part 33 of the rules of the CFTC (such contracts, "**Options**", and collectively with Futures, "**Futures Transactions**"). With respect to Foreign Futures, the FCM acts for the Customer by carrying Foreign Futures on the Customer's behalf with, and guaranteeing the Customer's performance to, clearing members ("**Foreign FCMs**") of the relevant foreign clearinghouses, which Foreign FCMs may frequently be affiliates of the FCM, and the Foreign FCMs will, in turn, enter into back-to-back futures transactions cleared by foreign clearinghouses;

2.2 each Covered Base Agreement is governed by New York law;

2.3 the Customer agrees to transfer, as applicable, initial margin and variation margin payments as the FCM may require in respect of the Customer's Futures Transactions. In addition, the Customer will, pursuant to such Covered Base Agreement, grant a security interest to the FCM in all of the Customer's rights in the following property, whether at the time of the grant or thereafter existing, and the proceeds of those rights:

2.3.1 "**Futures Credit Support**", including:

(i) its Account and all assets credited thereto, including assets held by a DCO, as well as other property of the Customer held in respect of Futures Transactions by or for the FCM, the DCO or any agent acting for the FCM, the DCO or the Customer (collectively, "**Futures Credit Support**");

(ii) with respect to Foreign Futures, its Account and all assets credited thereto, including assets held by a Foreign FCM or foreign clearinghouse, as well as

other property of the Customer held in respect of Futures Transactions by or for, or for the Account and due from, the FCM, any Foreign FCM, any foreign clearinghouse or others, or any agent acting for the FCM, any Foreign FCM, any foreign clearinghouse or others; and

2.3.2 "**Futures Payment Rights**", including:

(i) with respect to U.S. Futures and Options, its Futures Transactions and all rights to payment thereunder (whether constituting obligations of the FCM or a DCO); and

(ii) with respect to Foreign Futures, its Futures Transactions and all rights to payment thereunder (whether constituting obligations of the FCM, a Foreign FCM or a foreign clearinghouse).

The security interest secures all obligations of the Customer to the FCM under the Covered Base Agreement;

As a matter of strict legal interpretation, given that the assets credited to the customer Account and the Futures Transactions are held on trust for the customer, the security interest which the customer grants to the FCM will be a security interest over the customer's beneficial interest under the specific statutory trust in respect of the assets listed in limb 2.3.1 above and the beneficial interest under the "agent-trust" in respect of the Futures Transactions as opposed to creating security over the assets and Futures Transactions themselves.

2.4 a Covered Base Agreement contains one or more events of default (whether or not described therein as "events of default") (each, an "**Event of Default**") the effect of which is to give the FCM the right to liquidate (and thereby terminate) the Futures Transactions held in the Customer's Account ("**Futures Liquidation Rights**"). Among such Events of Default are defaults predicated on (A) a Customer's filing under applicable bankruptcy or similar insolvency laws, (B) the filing of a petition for the commencement of involuntary proceedings in respect of the Customer under applicable bankruptcy or similar insolvency laws which filing results in a judgment of insolvency or bankruptcy or an order for relief and (C) the appointment in respect of the Customer or substantially all of its assets of an administrator, conservator, receiver or similar official, including the possession and control of the property of the Customer by such an official pursuant to seizure orders.

2.5 a Covered Base Agreement includes a provision the effect of which is to permit the FCM, upon the occurrence of an Event of Default in respect of a Customer, to liquidate and/or carry out a valuation of all Futures Payment Rights and Futures Credit Support, as set out in paragraphs 2.5 to 2.7 of the Linklaters summary (a copy of which is attached here to as Appendix C). The FCM is entitled to reimburse itself out of the Futures Payment Rights or the Futures Credit Support (or the liquidation value thereof) for any liabilities, costs and expenses properly incurred in the performance of its agency.

2.6 pursuant to the terms of a Covered Base Agreement, following the exercise of its rights in limb (2.5) above, the FCM determines an aggregate net amount payable in connection with the liquidation or deemed liquidation (if applicable) of the Futures Transactions. This represents a determination of the overall value of the single course of dealing between the FCM and the Customer rather than the exercise of close-out netting or set off in respect of a number of different transactions (the "**Futures Determination of Account**"). If such amount is positive (and, therefore, represents a surplus for the FCM), the FCM will have a duty to

account for such amount to the customer or if such amount is negative (and, therefore, represents a deficit for the FCM), the customer will have a duty to account for such amount to the FCM.

With respect to each CDA, we understand that:

2.7 the CDA supplements a Covered Base Agreement with respect to, among other things, the liquidation and Determination of Account (as defined below) relating to "**Cleared Derivatives Transactions**" carried in the Customer's account holding Cleared Derivatives Transactions (the "**Cleared Derivatives Account**"), as well as the application of collateral related to those Cleared Derivatives Transactions. "**Cleared Derivatives Transactions**" are swaps, forwards, options, or similar transactions (but excluding Futures Transactions executed on or subject to the rules of a U.S. designated contract market or on a foreign board of trade and subject to regulation in that jurisdiction) that are (a) entered into by a Customer in the over-the-counter market, or (b) executed or traded by such Customer on or subject to the rules or protocols of any multilateral or other trading facility, system or platform, including any communication network or auction facility permitted under applicable law or any designated contract market and, in either case, subsequently submitted to and accepted for clearing by a DCO and subject to the CFTC's Part 22 rules. To the extent that a security-based swap is, in accordance with applicable law, carried by an FCM in a cleared swaps customer account (as defined in the CFTC's Part 22 rules), such security-based swap constitutes a Cleared Derivatives Transaction;

2.8 each CDA is governed by New York law;

2.9 in accordance with the CDA, the Cleared Derivatives Transactions become incorporated into the related Covered Base Agreement, which incorporation is accomplished by considering references to "Contracts," "Futures," "Futures Contracts" and similar terms in such Covered Base Agreement to include references to the Cleared Derivatives Transactions. Through this incorporation, the Customer grants a security interest to the FCM in all of the Customer's rights in the following property, whether at the time of the grant or thereafter existing, and the proceeds of those rights:

2.9.1 its Cleared Derivatives Account and all assets credited thereto, including assets held by a DCO, and (2) other property of the Customer held in respect of Cleared Derivatives Transactions by or for the FCM, the DCO and any agent acting for the FCM, the DCO or the Customer (collectively, "**Cleared Derivatives Credit Support**"); and

2.9.2 its Cleared Derivatives Transactions and all rights to payment thereunder (whether constituting obligations of the FCM or a DCO) and the customer's rights, if any, in all cash received by the FCM and all rights to payment in favour of the FCM or the customer arising out of or in connection with the exercise by the FCM of any right to terminate, liquidate or otherwise close out the customer's account or Cleared Derivatives Transactions (collectively, "**Cleared Derivatives Payment Rights**").

As a matter of strict legal interpretation, given that the assets listed in limb (2.9.1) above and the Cleared Derivatives Transactions are held on trust for the customer, the security will be over the customer's beneficial interest under the specific statutory trust in respect of the assets listed in limb (2.9.1) above and the beneficial interest under the "agent-trust" in respect of the Cleared Derivatives Transactions as opposed to creating security over the assets and Cleared Derivatives Transactions themselves.

2.10 the FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a Customer's Cleared Derivatives Transactions by way of a number of different methods and processes, as set out in paragraphs 2.8 and 2.9 of the Linklaters summary (such rights, the "**Cleared Derivatives Liquidation Rights**" and, together with the Futures Liquidation Rights, the "**Liquidation Rights**"). The FCM is also entitled to dispose of or realize on (i) all Cleared Derivatives Credit Support posted by the customer to the FCM in respect of Cleared Derivatives Transactions and (ii) any margin transferred to the customer under Cleared Derivatives Transactions. The FCM can reimburse itself out of such assets and the Cleared Derivatives Payment Rights (or the liquidation value thereof) for any liabilities, costs and expenses properly incurred in the performance of its agency.

2.11 pursuant to the terms of the CDA, following the exercise of its rights in limb (iv) above, the FCM determines an aggregate net amount payable in connection with the liquidation or deemed liquidation (if applicable) of the Cleared Derivatives Transactions. This represents a determination of the overall value of the single course of dealing between the FCM and the Customer rather than the exercise of close-out netting or set off in respect of a number of different transactions (together with the Futures Determination of Account, the "**Determination of Account**"). If such amount is positive (and, therefore, represents a surplus for the FCM), the FCM will have a duty to account for such amount to the customer or if such amount is negative (and, therefore, represents a deficit for the FCM), the customer will have a duty to account for such amount to the FCM.

2.12 There are two distinct routes by which an FCM can choose to exercise its Liquidation Rights: (i) by reliance on its contractual and trust entitlement under the Covered Base Agreement and/or the CDA (which does not need to involve the enforcement of any security interests) (the "**Trust Liquidation Rights**") or (ii) by way of enforcement of its security over the Customer's interest in the "agent-trust" and statutory trust (the "**Enforcement Liquidation Rights**"). Whichever route is preferred by the FCM, the exercise of the Liquidation Rights is carried out by the FCM as principal and not as agent pursuant to the exercise of its contractual and/or security rights under the Covered Base Agreement and/or the CDA (and in accordance with the terms of the applicable DCO rules).

2.13 A summary of the operation and legal basis by which an FCM exercises its Trust Liquidation Rights is set out in further detail in the Linklaters summary and, in particular, under paragraphs 2.12 to 2.15 thereof.

2.14 A summary of the operation and legal basis by which an FCM exercises its Enforcement Liquidation Rights is set out in further detail in the Linklaters summary and, in particular, under paragraphs 2.17 to 2.19 thereof.

2.15 The analysis in this Memorandum covers a Customer which is a form of counterparty listed in Appendix B. We understand that the types of transaction that may be entered into under a Covered Base Agreement and CDA include both Futures Transactions and Cleared Derivatives Transactions (together, "**Covered Transactions**"), of the type described in Appendix A to this Memorandum.

## 3 General Assumptions

3.1 We have made the following assumptions:

3.1.1 the Covered Transactions entered into by the Customer and the FCM pursuant to the Covered Base Agreement and the CDA provide for an exchange of cash payments or for the physical delivery of shares, bonds or commodities in exchange for cash;

3.1.2 the selection of New York law as the governing law (the "**Governing Law**") of each Covered Base Agreement and CDA has been or will be made in good faith and is or will be binding as a matter of the Governing Law;

3.1.3 the Customer is not acting as a multibranch party in entering into the Covered Base Agreement or the CDA;

3.1.4 subject to the opinions contained herein, a Covered Base Agreement, each Covered Transaction and a CDA will be validly authorised, executed and delivered by or on behalf of each party and will constitute legal, valid, binding and enforceable obligations of each party in accordance with their respective terms as a matter of the Governing Law and all other relevant laws;

3.1.5 the FCM has duly executed and delivered, with all requisite capacity and authority (having obtained any required governmental or other consents, approvals, authorizations, registrations or qualifications, provided any required governmental or other notices or filings and taken any other actions necessary for this purpose), and for bona fide commercial reasons and on arm's-length terms as principal and not as agent for any third party other than the Customer, each Covered Base Agreement, each CDA and any respective amendments of such documents;

3.1.6 the Customer has duly executed and delivered, with all requisite capacity and authority (having obtained any required governmental or other consents, approvals, authorizations, registrations or qualifications, provided any required governmental or other notices or filings and taken any other actions necessary for this purpose), and for bona fide commercial reasons and on arm's-length terms, its Covered Base Agreement, CDA, Futures Transactions and Cleared Derivatives Transactions and any respective amendments thereto and is personally liable as principal (other than in the circumstances where it acts through an agent) for its obligations and beneficially entitled as principal to its benefits under the Covered Base Agreement and each CDA. To the extent that the Customer acts through an agent or pursuant to a power of attorney, (a) the agent or attorney in fact has been validly appointed and duly authorized by the Customer to enter into a Covered Base Agreement and CDA with the FCM and to enter into Futures Transactions and Cleared Derivatives Transactions; (b) all of the agent or attorney in fact's activities in connection with a Covered Base Agreement, a CDA, any amendments thereto and any Futures Transactions and Cleared Derivatives Transactions are within the scope of its agency or power of attorney; (c) Futures Transactions and Cleared Derivatives Transactions entered into by the agent in its capacity as agent or the attorney in fact in its capacity as such for the Customer are allocated to a unique account or sub-account at the FCM separate from all other accounts or subaccounts to which Futures Transactions and Cleared Derivatives Transactions entered into by the agent or attorney in fact on behalf of other principals, or by the Customer as principal, are allocated; (d) the agent or attorney in fact of the Customer has no proprietary interest in the Customer's Covered Base Agreement, Account, Futures Transactions, CDA, Cleared Derivatives Account or Cleared Derivatives Transactions, in each case, by virtue of subrogation or otherwise; and I the agent or attorney in fact is solvent and not subject to any bankruptcy, insolvency, reorganization, moratorium, conservatorship or similar proceedings;

3.1.7 in so far as any obligation under the Covered Base Agreements, any CDA or any Covered Transaction, (including, for example, the obligation to make payments at a particular place or in a particular currency), is to be performed in any jurisdiction

outside the Cayman Islands, its performance will not be illegal or ineffective by virtue of the law of that jurisdiction;

3.1.8 the Covered Base Agreements, each CDA and any Covered Transaction are entered into in good faith and in the normal course of business and not with an intent to prefer, or at an undervalue or with an intent to defraud, any of their creditors and at a time which the Customer and the FCM are solvent and not subject to any winding up proceedings;

3.1.9 in circumstances where the Customer (including in the case of a Trust, the Trustee and, in the case of a Partnership, the General Partner) becomes insolvent and is the subject of winding-up proceedings, that such proceedings only take place in the Cayman Islands;

3.1.10 factual representations, warranties and undertakings contained in the Covered Base Agreements and each CDA will be accurate and complied with and all preconditions of the parties to the Covered Base Agreements and each CDA have been satisfied or duly waived; and

3.1.11 there is nothing under any other applicable law (other than the laws of the Cayman Islands) which would or might affect any of the opinions in this Memorandum.

## 4 Issues

*Would the parties' agreement on Governing Law of each Covered Base Agreement and CDA and submission to jurisdiction be upheld in the Cayman Islands, and what would be the consequences if it were not?*

4.1 The parties' agreement on Governing Law of each Covered Base Agreement and CDA and submission to jurisdiction would be upheld in the Cayman Islands assuming the choice of the Governing Law and submission to jurisdiction is made in good faith (that is, not with the intention of evading a mandatory provision of another law which is more closely connected with the transaction) and is valid as a matter of New York law, being the governing law. If the expressed Governing Law of the Covered Base Agreement and CDA were not upheld in the Cayman Islands, Cayman Islands law would apply unless one of the parties sought to maintain that another law should apply, in which case the Cayman Islands courts would seek to ascertain the proper law of the Covered Base Agreement and CDA. This would be the system of law with which the transaction is most closely connected.

*Would each of the methods by which an FCM can bring about the liquidation of a Customer's Futures Transactions and Cleared Derivatives Transactions (i.e. the Cleared Derivatives Liquidation Rights), as set out in paragraphs 2.8 and 2.9 of the Linklaters summary, be recognized and upheld in the Cayman Islands. If a particular method would either not be upheld or may be challenged, please provide further detail and explain the reason for this.*

4.2 We believe that valid contractual arrangements (as determined in accordance with the appropriate governing law of the applicable contract) for the termination of contracts would be respected in the Cayman Islands and therefore a contractual right of the FCM to exercise its Futures Liquidation Rights and Cleared Derivatives Liquidation Rights would be enforceable under the law of the Cayman Islands in voluntary or involuntary winding up or

other insolvency proceedings of the Customer[1]. The legal conclusion in the preceding sentence would also apply notwithstanding circumstances where the FCM acts in its capacity as the customer's agent or pursuant to a power of attorney granted by the customer to effect Offsetting Transactions and/or Sale/Novation Transactions for the account of the customer.

4.3 The bankruptcy, composition, rehabilitation (e.g. administration, receivership or voluntary arrangement) or other insolvency proceedings to which Customer would be subject in the Cayman Islands are the following:

4.3.1 the Companies Law: this is the principal law under which (i) a Company incorporated in the Cayman Islands, (ii) a foreign company falling within Section 91 of the Companies Law, and (iii) in certain circumstances, an Exempted Limited Partnership, are subject to insolvency proceedings (these are winding up proceedings and there is no formal corporate rehabilitation procedure – although schemes of arrangement[2] are available and are often used in conjunction with a provisional liquidation with the aim of avoiding a formal winding up);

4.3.2 the Bankruptcy Law (1997 Revision) (the "**Bankruptcy Law**"): the Bankruptcy Law is only relevant to Partnerships and allows proceedings to be taken against partners in the name of a Partnership. A bankruptcy petition presented against a Partnership under the Bankruptcy Law is an administratively convenient way of commencing bankruptcy proceedings against the partners to the extent those partners can be made subject to bankruptcy proceedings under the Bankruptcy Law. In general terms bankruptcy proceedings may be brought against individuals who are present, ordinarily resident, have a place of residence or carry on a business (either personally, through an agent or through a partnership of which they are a partner) in the Cayman Islands. If a partner of a partnership is not susceptible to bankruptcy jurisdiction (a provisional order under the Bankruptcy Law cannot be made against a company – the procedure for winding up companies incorporated in the Cayman Islands is provided for in the Companies Law) an order can still be made against the Partnership. English authority suggests that, in such a case, a petition may be presented against the Partnership "other than" the relevant partner. The procedure under the Bankruptcy Law is therefore not a proceeding against the partnership as such and is unlikely to be relevant in the context of the issues raised in this opinion (because most partnerships are unlikely to have individuals as partners who are subject to jurisdiction under the Bankruptcy Law); and

4.3.3 certain regulatory laws under which such parties may be licensed as a result of carrying on a regulated activity (such laws include the Banks and Trust Companies Law (2020 Revision) (the "**Banks and Trust Companies Law**"), the Mutual Funds Law (2020 Revision), the Securities Investment Business Law (2020 Revision) and the Insurance Law, 2010 (the "**Insurance Law**")): such laws make provision for the

[1] In respect of Companies and Exempted Limited Partnerships, support for this position is found in section 140(2) of the Companies Law (2020 Revision). Section 140(2) provides that "*the collection in and application of the property of the company referred to in subsection (1) is without prejudice to and after taking into account and giving effect to the rights of preferred and secured creditors and to any agreement between the company and any creditors that the claims of such creditors shall be subordinated or otherwise deferred to the claims of any other creditors and to any contractual rights of set-off or netting of claims between the company and any person or persons (including without limitation any bilateral or any multi-lateral set-off or netting arrangements between the company and any person or persons) and subject to any agreement between the company and any person or persons to waive or limit the same*" [emphasis added]. Section 140(1) provides that the company's property must be applied in satisfaction of its liabilities *pari passu*. The better view is that the emphasised wording in section 140(2) means that any contractual provision which has the effect of disapplying the *pari passu* principle is enforceable. Therefore, in our view, a Cayman Islands court should allow the Future Liquidation Rights and Cleared Derivative Liquidation Rights to be exercised. This is a general point and applies throughout this memorandum.

[2] Schemes of arrangement are not available for Partnerships.

appointment of controllers and liquidators to an entity regulated under the relevant regulatory law. As the provisions are very similar, the following discussion in relation to banks can be taken to be generally applicable to the other regulated entities. Sections 18(1)(iv) and (v) of the Banks and Trust Companies Law empowers the Cayman Islands Monetary Authority to appoint a controller to (a) advise the licensee on the proper conduct of its affairs and to report to the Cayman Islands Monetary Authority, or (b) assume control of the licensee's affairs who shall have all the powers of a person appointed as a receiver of a business appointed under section 18 of the Bankruptcy Law. It should be noted that this provision is not available to creditors generally. Furthermore, the powers may only be exercised if the Cayman Islands Monetary Authority is of the opinion that the licensee has breached the Banks and Trust Companies Law, has failed to comply with a condition of its licence, is carrying on its business in a manner detrimental to certain persons or the licensee is or it appears likely that the licensee will become unable to meet its obligations as they fall due. The controller is required to prepare a report for the Cayman Islands Monetary Authority and on receipt of such report the Cayman Islands Monetary Authority may revoke the license of the licensee and apply to the court for an order that the licensee be forthwith wound up by the court and in such winding up the provisions of the Companies Law relating to the winding up of a company apply. In our view, the exercise of these powers would result in the appointment of a liquidator of the Customer with the powers given to a liquidator by the Companies Law.

(the above are together called "**Insolvency Proceedings**").

*Would the "agent-trust" and statutory trust be recognized and upheld under the laws of the Cayman Islands as creating a valid trust over the relevant Customer transactions and assets whereby the FCM holds the legal title to the relevant customer transactions and assets and the Customer holds a beneficial interest in the trust as a whole (as opposed to maintaining an interest in any specific assets under the trust)?*

4.4 Yes, the agent-trust and statutory trust would be upheld in the Cayman Islands, assuming such agent-trust and statutory trust are legal, valid, binding and enforceable as a matter of New York law as their governing law.

*Would the exercise by the FCM of its Trust Liquidation Rights (including the operation of the Determination of Account), upon the occurrence of an Event of Default in respect of a customer, be recognized and upheld under the laws of the Cayman Islands.*

4.5 Yes, see section 4.2 and 4.3 above.

*Is there any risk that either the "agent-trust" or the statutory trust would be recharacterised under the laws of the Cayman Islands (e.g. as security)? If so, how would the exercise by the FCM of its Trust Liquidation Rights be characterised under the laws of the Cayman Islands.*

4.6 We do not believe that the Trust Liquidation Rights would be recharacterised as creating a security interest on the basis of the assumptions set out in this Memorandum, that is, on the basis that the Trust Liquidation Rights and the Governing Law would not recharacterise the Trust Liquidation Rights. However, as the applicable conflict of law rule in relation to recharacterisation is not free from doubt we believe that the recharacterisation risk under the *lex situs* should also be considered. If Cayman Islands law is relevant because such Trust Liquidation Rights are located in the Cayman Islands, we believe the English authorities would be regarded as persuasive and accordingly, provided the arrangement is not a sham, the court should respect the intentions of the parties.

*Under your jurisdiction, are any rights or processes available to a creditor of a customer by which such creditor could make a claim against the Customer assets held on the statutory trust or against the Futures Transactions and Cleared Derivatives Transactions (and any rights in respect thereof) held on the "agent-trust" by the FCM for the benefit of the Customer as opposed to only having recourse to the single net amount that constitutes the Determination of Account?*

4.7 Provided that under the relevant contractual provisions a creditor of a customer would not be able to make a claim against the Customer assets held on the statutory trust or against the Futures Transactions and Cleared Derivatives Transactions held on the "agent-trust" by the FCM for the benefit of the Customer, then, subject to the general insolvency rights set out in section 4.15 below, there are no rights or processes available to a creditor of customer which would enable such claims to be made.

*Assuming the parties have entered into a Covered Base Agreement and CDA, the Customer is insolvent and the FCM has determined a lump-sum termination amount in a currency other than the currency of the jurisdiction in which the insolvent Customer is organized would a court in your jurisdiction enforce a claim for the net termination amount in the currency in which it was determined?*

4.8 In the event of any proceedings being brought in the Cayman Islands courts to enforce an obligation to make a termination payment in a currency selected by the FCM other than Cayman Islands dollars, a Cayman Islands court will give judgment expressed as an order to pay in such termination currency or its Cayman Islands dollar equivalent at the time of payment or enforcement of the judgment. A Cayman Islands court has jurisdiction to give judgments expressed in foreign currencies under the Grand Court Rules Order 42, Rule 8.

4.9 Cayman Islands law may also require that all claims or debts be converted either into Cayman Islands dollars or the Customer's functional currency of account determined in accordance with applicable accounting principles at the exchange rate ruling at the date of commencement of a winding up of the Customer that is a Company. We believe this principle would also be relevant to Trusts and Partnerships to the extent insolvency proceedings are applicable. We would note that, pursuant to Order 16, Rule 13(6) of the Companies Winding Up Rules 2018 a creditor is not entitled to claim against an insolvent Company or Exempted Limited Partnership in liquidation any compensation for exchange losses resulting from changes in the market exchange rate occurring during the period between the date on which the winding up order was made and the date on which the dividend is paid.

*Can a claim for the net termination amount be proved in insolvency proceedings in the Cayman Islands without conversion into the local currency?*

4.10 A claim can be made in any proceedings in the Cayman Islands courts for an amount in a currency other than Cayman Islands dollars, however, the Cayman Islands court would give judgment expressed either as an order to pay such currency or its Cayman Islands dollar equivalent at the time of payment or enforcement of the judgment. A Cayman Islands court has jurisdiction to give judgments expressed in foreign currencies under the Grand Court Rules Order 42, Rule 8.

4.11 Although there is no statutory enforcement in the Cayman Islands of judgments obtained in New York, a judgment obtained in such jurisdiction will be recognised and enforced in the courts of the Cayman Islands at common law, without any re-examination of the merits of the

underlying dispute, by an action commenced on the foreign judgment debt in the Grand Court of the Cayman Islands, provided such judgment:

4.11.1 is given by a foreign court of competent jurisdiction;

4.11.2 imposes on the judgment debtor a liability to pay a liquidated sum for which the judgment has been given;

4.11.3 is final;

4.11.4 is not in respect of taxes, a fine or a penalty; and

4.11.5 was not obtained in a manner and is not of a kind the enforcement of which is contrary to natural justice or the public policy of the Cayman Islands.

*Are there any other Cayman Islands law considerations that you would recommend the FCM to consider in connection with the exercise of the Trust Liquidation Rights (including the operation of the Determination of Account)?*

4.12 No. Cayman Islands law would look to honor the terms of any such Trust Liquidation Rights (including the operation of the Determination of Account) assuming such Trust Liquidation Rights are enforceable as a matter of their governing law.

*Are there any other circumstances you can foresee that might affect the FCM's ability to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) in the Cayman Islands?*

4.13 No, not as a matter of Cayman Islands law.

*Assuming that the FCM's ability to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) in the Cayman Islands will be recognized in the Cayman Islands, will such rights be capable of exercise without recourse to or enforcement of the Trust Security Interest or any Collateral Security Interest described below?*

4.14 The right of the FCM to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) will be recognized and, therefore, capable of existence without recourse to or enforcement of the Trust Security Interest or any Collateral Security Interest, as a matter of Cayman Islands law, assuming that such exercise without enforcement is legal, valid, binding and enforceable under the Consumer Base Agreement and CDA and as a matter of New York law as the governing law of each Consumer Base Agreement and CDA.

*General Insolvency Issues Affecting Companies and Exempted Limited Partnerships, as applicable*

4.15 The enforceability of the Consumer Base Agreement and CDA will also be subject to general insolvency rules applicable to Companies and, in some cases, Exempted Limited Partnerships, including:

(a) Voidable Preference under the Companies Law – the entry by a Company or Exempted Limited Partnership into a Covered Transaction at any time within the six months immediately preceding the commencement of its winding up is, depending on the exact facts, theoretically capable of constituting a voidable preference if the pre-

conditions for a voidable preference under Section 145(1) of the Companies Law were present. In accordance with Section 145(1), every conveyance or transfer of property or charge therein, every payment, every obligation and every judicial proceeding made, incurred, taken or suffered by any Company or Exempted Limited Partnership which is unable to pay its debts as they become due from its own monies in favour of any creditor with a view to giving such creditor a preference over the other creditors will be invalid if made within, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation. Cayman Islands law provides that there must be a dominant intention to prefer the creditor. If the Company's or Exempted Limited Partnership's primary purpose in entering into the transaction was to achieve something other than preferring a creditor, then it should not be a voidable preference, even if preferring that creditor was a collateral effect of that payment. In practice, we believe it is unlikely the Company or Exempted Limited Partnership's entry into a Covered Transaction on an arm's length basis would be regarded as a voidable preference. It would be extremely difficult to infer the necessary intention to prefer one creditor over another as the sum payable by way of liquidated damages (if any) by one party on early termination is dependent upon movements in market rates over which the parties have no control. It would therefore be impossible to predict with certainty what the outcome will be at any time in the future. Section 145(1) only applies to Exempted Limited Partnerships upon an involuntary winding up or dissolution of such Exempted Limited Partnership.

(b) Avoidance of dispositions made at an undervalue under the Companies Law – in accordance with Section 146(2) of the Companies Law, every disposition of property made at an undervalue by or on behalf of a Company or Exempted Limited Partnership with intent to defraud its creditors shall be voidable at the instance of its official liquidator. The burden of establishing an intent to defraud for the purposes of section 146(2) shall be upon the official liquidator. See the comments below in relation to the Fraudulent Dispositions Law (1996 Revision).

(c) Intention to defraud (fraudulent trading) – if in the course of the winding up of a Company it appears that any business of the Company or Exempted Limited Partnership has been carried on with intent to defraud creditors of the Company or creditors of any other person or for any fraudulent purpose the liquidator may apply to the Court for a declaration under Section 147(1) of the Companies Law. Section 147(1) shall only apply to Exempted Limited Partnerships upon an involuntary winding up or dissolution of such Exempted Limited Partnership.

(d) The Fraudulent Dispositions Law (1996 Revision) may have the effect of making a Transaction or a payment or transfer voidable (although it is not an insolvency related provision as such as it applies both pre and post insolvency). Under the Fraudulent Dispositions Law (1996 Revision) any disposition of property made with an intent to defraud (which means an intention wilfully to defeat an obligation owed to another creditor) and at an undervalue is voidable at the instance of the creditor thereby prejudiced. A creditor may only commence an action under this Law within 6 years of the relevant disposition. Given the requirement for undervalue (which means the provision of no consideration for the disposition or a consideration the value of which in money or money's worth is significantly less than the property the subject of the disposition) we believe it is unlikely that this Law would apply to Covered Transactions made on arms' length terms or payments or transfers made pursuant to contractual obligations under such Covered Transactions.

(e) There is a further circumstance in which a creditor of a Company may be made subject to an arrangement or compromise affecting his rights without his consent. A creditor of a Cayman Islands Company may have a compromise or arrangement imposed upon him under section 86(1) of the Companies Law if a majority in number representing three fourths in value of the creditors (or class of creditors including the affected creditor) have approved a compromise or arrangement and it has been sanctioned by the Grand Court of the Cayman Islands. It may be that on a particular set of facts a Counterparty would constitute a separate class and therefore have the power to veto any such compromise or arrangement. A class is constituted by "those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their acting in their common interest".

(f) Void dispositions – section 99 of the Companies Law provides that, when a winding up order has been made in respect of a Company, any disposition of the Company's property and any transfer of shares or alteration in the status of the Company's members made after the commencement of the winding up is, unless the Court otherwise orders, void. If the counterparty and the Company enter into Covered Transactions or the Company makes a payment under a Covered Transaction after the commencement of the Company's winding up without the approval of the Grand Court, such transaction or payment would be void.

(g) We confirm that a liquidator of an insolvent Company in the Cayman Islands has no statutory right to disclaim onerous contracts or "cherry pick". Contracts are not automatically terminated by the liquidation of one of the parties (unless the contract specifically provides for this), nor is the other party released from its obligations. The liquidator succeeds to all the rights and obligations of the insolvent party and is not entitled to avoid obligations or other contractual consequences arising as a result of the liquidation[3]. We believe also that a liquidator would have no common law right to disclaim onerous contracts based on the English case *In re Katherine et Cie, Limited* [1932] 1 Ch (which would be persuasive but not binding in the Cayman Islands): in this case there is a clear judicial statement that prior to the introduction of the statutory right of a liquidator to disclaim contracts in the English Companies Act of 1929, there was no common law right to do so. Even if we are wrong in our opinion that a Cayman Islands liquidator has no right to disclaim onerous contracts a liquidator certainly has no right to pick and choose between different parts of the same contract, in other words, to seek to enforce rights of the Company to cash payments or the delivery of physical securities under one Covered Transaction, as the case may be, but to disclaim obligations to make the same under others. Accordingly, even if such a power does exist, it is still our opinion that the Covered Base Agreement and CDA will be upheld against a liquidator to the extent that it (together with the Covered Transactions) is construed as a single contract as a matter of the Governing Law.

(h) In the context of proceedings taken against a partner of a partnership under the Bankruptcy Law, there are specific provisions in the Bankruptcy Law which allow a trustee in bankruptcy to disclaim onerous contracts. Whilst we believe that disclaimer could apply to Trust Liquidation Rights (including the operation of the Determination of Account), we do not believe that it could apply to different parts of the same contract and any such disclaimer would apply only to entire contracts. However, the entry into a Transaction under the Covered Base Agreement as part of

[3] This is subject to two limited exceptions. First, where a contractual provision was not intended to apply in liquidation it may not bind the liquidator. Secondly, pursuant to the rule in *ex parte James*, a liquidator may not be able to rely on a contractual provision where it would be unfair on creditors for him to do so.

the disposition of collateral over which the FCM has a pre-existing security interest would not be subject to this provision.

*Segregated Portfolio Companies*

4.16 Whilst segregated portfolio companies are subject to the insolvency provisions of the Companies Law there are particular rules which apply to them under the Companies Law and these are discussed below.

4.17 Under Part XIV of the Companies Law, the assets and liabilities of a segregated portfolio company are allocated to segregated portfolios as determined by the directors or to the general assets of the company. In order for any liability or asset to be binding on or enure to the benefit of a segregated portfolio, that liability or asset must be contracted for by the segregated portfolio company on behalf of the relevant segregated portfolio and any written contract must identify the relevant segregated portfolio to which such asset or liability relates. Under the Companies Law, assets of a segregated portfolio may only be used to meet liabilities attributable to that segregated portfolio and are not available to meet liabilities attributable to any other segregated portfolio notwithstanding that the segregated portfolios are simply segregated pools of assets and liabilities of the same legal entity and the segregated portfolios themselves do not constitute separate legal entities. In a winding up of a segregated portfolio company, the liquidator is required to deal with the company's assets in discharge of liabilities attributable to a segregated portfolio in accordance with Part XIV and Section 140(2) of the Companies Law (which contain the statutory recognition of contractual rights to set-off or net claims), which are to be applied to segregated portfolio companies in accordance with Part XIV. In the event of any conflict between Section 140(2) and Part XIV, Part XIV will prevail.

4.18 As a result of these provisions, we believe that it is not possible to enforce contractual rights such as Trust Liquidation Rights (including the operation of the Determination of Account), both pre and post insolvency, of a liability attributable to one segregated portfolio against an asset attributable to another segregated portfolio notwithstanding that the liability and asset are the liability and asset of the same legal entity (i.e. the segregated portfolio company). This is because were such contractual rights permitted, the result would be that the assets of one segregated portfolio would be used to meet the liabilities of another which is prohibited under Part XIV. To the extent the liquidated damages or contractually agreed termination payment analysis applies this may be effective as it does not strictly involve using assets of one portfolio to settle liabilities of another, although some redrafting of the Covered Base Agreement and CDA may be required to achieve this.

4.19 If multiple transactions are entered into with one segregated portfolio, the usual rules in Section 140(2) of the Companies Law relating to the collection in and application of the property of the portfolio will continue to apply to the Trust Liquidation Rights (including the operation of the Determination of Account) in respect of that segregated portfolio. It is likely that as a commercial matter the intention of the parties will be that a particular segregated portfolio should be treated like a separate legal entity and the parties will have no expectation of the contractual rights in respect of Covered Transactions entered into with one segregated portfolio apply against those entered into with another.

4.20 The court also has the power to make receivership orders in respect of segregated portfolios where the court is satisfied that (i) the assets attributable to the segregated portfolio and, if relevant, the general assets of the company are or are likely to be insufficient to discharge the claims of creditors of that segregated portfolio in full and (ii) that the making of a receivership order would achieve the orderly closing down of the business carried on by the

segregated portfolio and the distribution of the segregated portfolio assets attributable to the segregated portfolio to those entitled to have recourse to them. An application for a receivership order may be made by the segregated portfolio company itself, the directors of the company, any creditor of the company and any holder of shares referable to the relevant segregated portfolio and, if the segregated portfolio company is regulated by the Cayman Islands Monetary Authority, the Cayman Islands Monetary Authority.

4.21 A receivership order may not be made if the Company is already in winding up. A resolution for the voluntary winding up of a segregated portfolio company of which any segregated portfolio is subject to a receivership order is ineffective without leave of the court. There is no general requirement for creditors of a segregated portfolio to be notified in advance of an application for a receivership order being made. This means that secured creditors will not be able to pre-empt the application for a receivership order by petitioning to wind up the Company unless they are otherwise aware that an application for a receivership order is to be made.

*Trusts*

*The Nature of a Trust*

4.22 A Trust is not a separate legal entity as a matter of Cayman Islands law. It is a fiduciary relationship whereby a fund is held by the Trustee that is subject to equitable obligations to deal with the fund under the terms of the trust instrument and in equity for the benefit of the beneficiaries who may enforce such equitable obligations.

4.23 The Trustee will typically although not necessarily delegate certain functions to advisors, managers or other agents who will often have the authority, based on such delegation, to act on behalf of the Trustee and to execute documents on its behalf.

4.24 The Trustee is personally liable for obligations it incurs, even if expressed to be incurred as trustee, in the sense that they are obligations of the Trustee and it can be sued personally on them. If it has duly entered into the obligations as trustee of the Trust, it will have a right to discharge those obligations out of the trust funds, or if it pays them out of its own resources, to be indemnified or reimbursed out of the trust funds (such indemnity may be excluded or limited in the trust deed). If the trust funds are insufficient to meet the liability in full (assuming the Trustee's right to the indemnity has not been excluded), the Trustee will be personally liable to the relevant creditor for the balance. Trusts therefore do not afford limited liability as a matter of their structure. It is permissible, however, for the Trustee to enter into contracts which themselves provide limitations of liability or recourse as a matter of contract. In certain circumstances the Trustee may also have a personal indemnity from the beneficiaries but this right is usually excluded in the trust deed.

4.25 The discussion below considers whether certain rights are enforceable in the context of a solvent or insolvent Trust where the Trustee, being a Company incorporated in the Cayman Islands, is either solvent or subject to winding up proceedings in the Cayman Islands.

4.26 If the trustee of the Trust is not incorporated in the Cayman Islands then the insolvency rules of the jurisdiction in which the trustee is established will need to be investigated.

*Solvent Trust, Insolvent Trustee*

4.27 On a winding up of a Trustee, assets held by the Trustee as trustee and their proceeds (provided they have not been mixed with the general assets of the Trustee and are readily

identifiable) would not be available to satisfy the claims of general creditors of the Trustee (as such assets and their proceeds will be held on trust for the beneficiaries of the Trust), except:

4.27.1 to the extent that the Trustee has a personal right against such assets under the Trust (e.g. an indemnity for expenses); or

4.27.2 in respect of a secured creditor granted security over assets of the Trust, such a creditor would be entitled to rely on such security interest in such assets (at least to the extent the security was granted by the Trustee in accordance with its rights, powers and duties under the Trust).

4.28 If the Trust is solvent but the Trustee is in winding up proceedings, we believe that the exercise of the Trust Liquidation Rights and the Determination of Account should be effective as a contractual matter and that no insolvency rule should apply to displace this. The insolvency rules applicable to companies incorporated in the Cayman Islands (in particular the requirement for *pari passu* distribution of assets) should not be relevant as the assets held by the Trustee as assets of the Trust (assuming they have not been mixed with the personal assets of the Trustee and are readily identifiably) are not available to the Trustee's general creditors in any event. Furthermore, even if a *pari passu* rule did apply to the distribution of the assets of the Trust, the Trust is solvent and so all creditors in respect of obligations regarding the Trust can be paid in full (even if the Trustee's general creditors cannot).

*Insolvent Trust, Solvent Trustee*

4.29 There are no specific insolvency proceedings in the Cayman Islands applicable to an insolvent Trust and no specific rules regarding how assets related to an insolvent Trust will be distributed amongst the outstanding creditors in respect of the Trust. In such circumstances, where the Trust fund is insufficiently valuable to discharge the contractual obligations regarding the Trust, the Trustee will bear the shortfall itself unless its liability is expressly limited in recourse to the Trust assets as a contractual matter. If a creditor in respect of an obligation regarding the Trust has a valid security interest over the Trust assets, such a creditor should be able to realise his security out of the secured Trust assets ahead of the other creditors in respect of the Trust (subject to the application of general insolvency rules, for example, fraudulent disposition – see further paragraphs 4.42 – 4.45 below). Where the Trustee is faced by claims of competing unsecured creditors in respect of obligations regarding the trust, there are no statutory rules which are applicable and, as far as we are aware, no relevant Cayman Islands case law. In our view, there are two alternative distribution methodologies which are likely to apply to the distribution of an insolvent trust's assets.

4.29.1 first, by ranking in time, so that the liability which arose first would be met first [4] (and in our view the contractual terms applying to the liability, including the Trust Liquidation Rights including the Determination of Account, would be binding on the trustee) ; or

4.29.2 secondly, on a *pari passu* basis[5].

[4] On the basis of the equitable principle that where there are competing equities the first in time should prevail.

[5] Either by analogy to the position under the Companies Law or because it is just and equitable to do so. It should be noted that the Royal Court of Jersey in *Rawlinson & Hunter Trustees SA v Z II Trust & ors* [2018] JRC 119 on an application for directions from a trustee applied a *pari passu* basis of distribution. This was primarily on the basis that it was just and equitable to do so. The decision of the Royal Court of Jersey is likely to be persuasive before a Cayman Islands court. This is particularly the case because the

4.30 Given the uncertainty as to the correct method of distribution, the Trustee is likely to refer the matter to the court for a determination[6]. The court has an equitable discretion to determine how to deal with matters arising in relation to the administration of a Trust, such as the payment of creditors to effect the orderly distribution of the Trust assets. We believe that there should be no basis on which a court may ignore an otherwise enforceable contractual rights relating to the determination of the overall value of the single loss of dealing between the FCM and a Customer in such proceedings, including in circumstances where the court might impose a *pari passu* basis of distribution of Trust assets (see the discussion in paragraphs 4.26 – 4.29 below).

4.31 Therefore, we believe that there should be no basis arising out of the insolvency of the Trust on which the Trustee or a court (in an application under the Trusts Law (2020 Revision) would refuse to enforce the Trust Liquidation Rights, including the Determination of Account under the Covered Base Agreement and the CDA.

*Insolvent Trust, Insolvent Trustee*

4.32 If the Trust is insolvent and the Trustee is subject to winding up proceedings, then whilst the analysis in paragraph 4.23 would still be applicable in relation to the Trustee's general creditors, the Trustee would also be liable to creditors in respect of obligations regarding the Trust and hold assets of the Trust (and its own general assets which would also be available to such creditors assuming the obligations regarding the Trust are not limited in recourse to the trust assets) which are insufficient to meet such obligations. In the absence of any insolvency rules applicable to Trusts, it is likely that if the matter came before a Cayman Islands court (because orders are sought from the court under the Trusts Law (2020 Revision) or because it is considered as part of a separate distribution scheme in relation to the Trust assets in the winding up of the Trustee) the court could, in our view, either order that the trust assets be distributed: (i) on a first in time basis; or (ii) a *pari passu* basis (see paragraphs 4.24.1 and 4.24.2 above).

4.33 If following consideration of the Trust Liquidation Rights, including the Determination of Account, under the Covered Base Agreement and CDA, a *pari passu* rule is applied then, although there is no authority on the point, we believe that a court should also allow the Trust Liquidation Rights, including the Determination of Account, and respect the contractual agreement between the parties.

4.34 If the court determines that a *pari passu* rule applies in circumstances where Trust assets are to be applied to meet claims of the creditors related to the Trust, we believe it would produce an unfair and unexpected result if it was not also accepted that mutuality exists in the broad sense that assets of the Trust are being used to satisfy liabilities related to the Trust. Accordingly whilst there is no authority exactly on this point in the Cayman Islands or, we believe, in England (which would otherwise be persuasive but not binding in the Cayman Islands), we believe that the fact that a Trust is insolvent and that the Trustee is in winding up, should not affect the enforceability of contractual arrangements, exercise of the Trust Liquidation Rights including the Determination of Account, under the Covered Base Agreement and the CDA either because no insolvency rules apply to the Trust (and therefore

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Royal Court of Jersey relied on a number of English and common law cases which are likely to be equally relevant should the matter come before the Cayman Islands court. We also note that the New Zealand and Australian courts have also applied a *pari passu* basis of distribution. Therefore, the direction of travel is that distributions should be made on a *pari passu* basis and we would expect, but could not guarantee, that if the matter came before a Cayman Islands court that they would apply a *pari passu* basis of distribution.

[6] A Trustee has power to seek advice and directions from the court under section 48 of the Trusts Law (2020 Revision).

the *pari passu* rule is irrelevant) or because, if a *pari passu* rule does apply, such calculation and determination should be permitted and sufficient mutuality should be established.

*General Insolvency Issues in relation to Trusts*

4.35 The general insolvency issues discussed above in paragraph 4.10 in relation to Companies and, in some cases, Exempted Limited Partnerships, will apply to the Trustee.

*Partnerships*

*The Nature of a Partnership*

4.36 A Partnership is not a separate legal entity under Cayman Islands law. The General Partner is liable for partnership debts (i.e. debts validly contracted for on behalf of the Partnership) to the extent the assets of the Partnership are insufficient to meet such debts, unless the General Partner has limited a creditor's claim or recourse to the Partnership assets. The General Partner enters into all agreements on behalf of the Partnership under general legal principles of agency as modified by the terms of the partnership agreement and either the Partnership Law or the Exempted Limited Partnership Law, as appropriate. It should be noted that at least one General Partner of an exempted limited partnership formed under the Exempted Limited Partnership Law must be either incorporated in the Cayman Islands, an exempted limited partnership, a foreign company registered in the Cayman Islands or an individual resident in the Cayman Islands.

4.37 There are no statutory insolvency proceedings in respect of Partnerships other than certain provisions in the Bankruptcy Law (1997 Revision) (the "**Bankruptcy Law**") and, in the case of exempted limited partnerships, a general power given to the court under the Exempted Limited Partnership Law to decree dissolution of an exempted limited partnership and make such orders in connection with the winding up of its affairs as the court thinks just and equitable. A Partnership may have a General Partner that is not established in the Cayman Islands and in such a case we recommend that the insolvency rules applicable in the jurisdiction in which such General Partner is established be checked to ensure that there is nothing under the applicable local law which may affect the enforceability of the contractual arrangements, exercise of the Trust Liquidation Rights, including the Determination of Account. The following discussion assumes that the General Partner is incorporated in the Cayman Islands.

*Bankruptcy Law*

4.38 The Bankruptcy Law allows proceedings to be taken against partners in the name of a Partnership. A bankruptcy petition presented against a Partnership under the Bankruptcy Law is an administratively convenient way of commencing bankruptcy proceedings against the partners to the extent those partners can be made subject to bankruptcy proceedings under the Bankruptcy Law. In general terms bankruptcy proceedings may be brought against individuals who are present, ordinarily resident, have a place of residence or carry on a business (either personally, through an agent or through a partnership of which they are a partner) in the Cayman Islands. If a partner of a Partnership is not susceptible to bankruptcy jurisdiction (a provisional order cannot be made against a company under the Bankruptcy Law – the procedure for winding up companies incorporated in the Cayman Islands is provided for in the Companies Law) an order can still be made against the Partnership. English authority suggests that, in such a case, a petition may be presented against the Partnership "other than" the relevant partner. The procedure under the Bankruptcy Law is therefore not a proceeding against the Partnership as such and is unlikely to be relevant in

the context of the issues raised in this Memorandum (because most Partnerships are unlikely to have individuals as partners who are subject to jurisdiction under the Bankruptcy Law). It should be noted that to the extent that proceedings are taken under the Bankruptcy Law set-off would be mandatory under section 127 of the Bankruptcy Law in respect of mutual credits, mutual debts and other amounts due between the Customer and a FCM under each Covered Base Agreement as a result of mutual dealings.

*Partnerships, excluding Exempted Limited Partnerships*

*Solvent Partnership, Insolvent General Partner*

4.39 If the Partnership is solvent but the General Partner, being a company incorporated in the Cayman Islands, is in winding up proceedings, we believe that effective contractual arrangements for the calculation and determination of the Determination of Account by the exercise of the Trust Liquidation Rights should be effective and that there should be no basis on which they could be challenged simply as a result of the existence of winding up proceedings in respect of the General Partner. We believe that the insolvency rules applicable to Companies (in particular the requirement for *pari passu* distribution of assets) should not affect the outcome because the Partnership assets held by the General Partner are not available to the General Partner's general creditors[7]. Furthermore, even if the Partnership assets were required to be distributed on a *pari passu* basis to the Partnership's creditors, the Partnership is solvent and so all Partnership creditors can be paid in full (even if the General Partner's general creditors cannot).

*Insolvent Partnership, Insolvent General Partner*

4.40 If the Partnership is insolvent and the General Partner is in winding up, then whilst the above analysis would still be applicable in relation to the General Partner's general creditors, the General Partner would also be liable to Partnership creditors and hold assets, both Partnership assets and, if the creditor's claim has not been limited to the Partnership assets, its own general assets, which are insufficient to meet such claims.

4.41 In these circumstances, if the General Partner is a company incorporated in the Cayman Islands or is registered as a foreign company under the Companies Law, such General Partner will be subject to the statutory rights provided by Section 140 of the Companies Law. Accordingly, subject to the qualifications discussed above, any contractual rights of calculation and determination of the Determination of Account by the exercise of the Trust Liquidation Rights would be respected.

4.42 In the absence of any insolvency rules applicable to a Partnership, we believe it is likely that if the matter came before a Cayman Islands court, either because orders are sought under the Partnership Law or because it is considered as a separate distribution scheme of the Partnership assets in the winding up proceedings relating to the General Partner, the court may either deal with the matter on the basis that the insolvency of the Partnership does not affect the analysis because there are no separate insolvency rules applicable to the partnership or the court may apply a *pari passu* basis of distribution (they may do this by analogy with the position under the Exempted Limited Partnership Law and the Companies Law or simply because it is a just and equitable basis to proceed). If a *pari passu* rule is applied then, although there is no authority on the point, we believe that a court would also

[7] Section 16(1) of the Exempted Limited Partnership Law provides for Partnership assets to be held or deemed to be held by the General Partner and, if more than one then by the General Partners jointly, upon trust as an asset of the partnership in accordance with the terms of the partnership agreement. The assets of a Partnership formed under the Partnership Law would be held jointly. The General Partner's rights under the partnership agreement in respect of such assets would be an asset available to its creditors.

allow the Determination of Account by the exercise of the Trust Liquidation Rights and respect the contractual agreement between the parties.

4.43 Having accepted that a *pari passu* rule applies in circumstances where Partnership assets are to be applied to meet claims of the Partnership's creditors, it would produce an unfair and unexpected result if it was not also accepted that mutuality exists in the broad sense that Partnership assets are being used to satisfy Partnership liabilities. Accordingly whilst there is no authority on this point in the Cayman Islands or, we believe, in England (which would otherwise be persuasive but not binding in the Cayman Islands)[8] we believe that the fact that a Partnership is insolvent and that the General Partner is in winding up should not affect the enforceability of the effective contractual obligations, such as the Trust Liquidation Rights, either because there are no insolvency proceedings which apply that are capable of displacing the otherwise effective contractual rights or, if there are insolvency proceedings, they recognise the contractual rights and mutuality is not an issue.

*Insolvent Partnership, Solvent General Partner*

4.44 If the Partnership is insolvent but the General Partner is solvent and not in winding up proceedings we believe that the position would be the same as that discussed in paragraphs 4.34 – 4.39. As the General Partner is not in winding up the basis of any possible insolvency proceedings is limited to orders sought under the Exempted Limited Partnership Law.

*Changes to Partners*

4.45 We would also mention that it has been suggested that changes of partners may give rise to mutuality issues because of the change of ownership of assets or in relation to changes of General Partners, changes to those liable in respect of claims. We do not consider this to be an issue (at least on the asset side) in relation to Exempted Limited Partnerships because of the entity type attributes accorded to them under the Exempted Limited Partnership Law, in particular, the fact that the assets are expressed to be held by the General Partner on trust for the Partnership and the fact that it is expressly provided that a change of limited partner or General Partner does not terminate or dissolve the Partnership. We think it would be usual in practice for liabilities of an outgoing General Partner of an Exempted Limited Partnership to be novated as no outgoing General Partner would wish to remain liable for partnership obligations. Limited partnerships formed under the Partnership Law (which are less common) may be affected by this issue but in practice liabilities would be novated and assets would be transferred in respect of any departing partner. It should also be noted that this point should not affect effective contractual arrangements under the same agreement because unless there is a transfer or novation the parties entitled to or liable under the agreement would remain the same.

*General Insolvency Issues Affecting Partnerships*

4.46 The general insolvency issues discussed above in paragraph 4.10 in relation to Companies and, in some cases, Exempted Limited Partnerships, will apply to the General Partner. There are no generally applicable insolvency provisions affecting Partnerships (other than Exempted Limited Partnerships) as such other than pursuant to the Bankruptcy Law.

[8] There is authority in England in relation to the setting off of personal claims or personal liabilities of a partner against partnership liabilities and assets see e.g. *Piercy v Fynney* (1871) L.R. 12 Eq 69 and *Jones v Fleeming* (1827) 7 B&C 217 (which say that this is not permitted unless, in the case of a partnership liability, a partner is wholly liable for such debt when such debt may be set off against a personal claim of the partner).

4.47 If proceedings are taken against the Partnership in the partnership name under the Bankruptcy Law we believe the substantive provisions of the Bankruptcy Law relating to insolvency would apply. In the case of Exempted Limited Partnerships, the provisions discussed in paragraph 4.10 should instead apply. The following paragraphs summarise the principal provisions.

4.48 Section 111(1) of the Bankruptcy Law makes void any fraudulent preference in similar circumstances to voidable preferences under section 145(1) of the Companies Law except that it applies when the relevant step is made, incurred, taken or suffered within six months before the provisional order takes effect. Furthermore section 107(1) of the Bankruptcy Law makes void any settlement (which means a conveyance, gift or transfer of property) made within two years before a provisional order takes effect except where, inter alia, the settlement is made in favour of a purchaser or incumbrancer in good faith and for valuable consideration. It should be noted that a provisional order is deemed to have effect from the first "act of bankruptcy" committed by the debtor within six months preceding the date of presentation of the bankruptcy petition (provided at that time the debtor was indebted to a creditor(s) in an amount sufficient to support a petition (CI$40 (approx. US$49) and such debt or debts were still outstanding at the date of the provisional order). The effect of a provisional order is to vest all the bankrupt's property in the trustee with the result that any disposition made from the first act of bankruptcy is void. However, section 118 of the Bankruptcy Law validates certain transactions (including the payment of debtors, conveyance of property and grant of security) occurring prior to the filing of the petition but after the first act of bankruptcy provided the other party had no notice of any act of bankruptcy which could have formed the basis of a petition at the time the petition was filed. Any act of bankruptcy must have occurred within six months of the presentation of the petition to form the basis of that petition. The possible acts of bankruptcy are set out in section 14 of the Bankruptcy Law.

4.49 Sections 105 and 106 of the Bankruptcy Law allow a trustee in bankruptcy to disclaim (inter alia) onerous contracts (although not parts of the same contract). Onerous contracts are leases burdened with onerous contracts, unmarketable shares, unprofitable contracts or any other property that is unsaleable, or not readily saleable by reason of it binding the possessor thereof to the performance of any onerous act or to the payment of any sum of money. There is no Cayman Islands authority on the meaning of "onerous contracts" for these purposes but we believe the interpretation of the equivalent provision in the English Insolvency Act 1986 would be regarded as persuasive, although not binding, by the courts in the Cayman Islands. In general terms assets are onerous where they are subject to a liability restriction or constraint – the onerous aspect does not necessarily have to impose a positive obligation but can be negative in character. Whilst, in our view, disclaimer could apply to certain contractual rights, in our view, it could not apply to different parts of the same contract and any such disclaimer would apply only to entire contracts (i.e. a trustee in bankruptcy has no rights to cherry pick or disclaim parts of a single agreement).

*General Enforceability Qualifications Affecting Companies, Trusts and Partnerships*

4.50 The term "enforceable" means that the obligations assumed by the Customer under the Agreements are of a type which the courts of the Cayman Islands enforce. It does not mean that those obligations will necessarily be enforced in all circumstances in accordance with their terms. We would draw to your attention the following general limitations:

4.50.1 enforcement may be limited by general principles of equity for example, equitable remedies such as specific performance for the delivery of physical securities may not be available, inter alia, where damages are considered to be an adequate remedy;

4.50.2 claims may become barred under statutes of limitation or may become subject to defences of counterclaims, estoppel, laches and similar defences;

4.50.3 nominal Cayman Islands stamp duty will be payable if the Covered Base Agreement, CDA or any transfer of physical securities is brought to or executed in the Cayman Islands;

4.50.4 a determination or calculation of any party to the Covered Base Agreements or CDAs as to any matter provided therein might be held by a Cayman Islands court not to be conclusive, final and binding if, for example, it could be shown to have an unreasonable or arbitrary basis or in the event of manifest error;

4.50.5 obligations to make payments that may be regarded as penalties will not be enforceable to the extent that they are penal; and

4.50.6 the obligations of the Customer which involve the government of any country which is currently the subject of United Nations sanctions extended to the Cayman Islands by Order or Orders in Council (an "**Affected Country**"), any person or body resident in, incorporated in or constituted under the laws of any Affected Country or exercising public functions in any Affected Country or any person or body controlled by any of the foregoing or by any person acting on behalf of any of the foregoing or any other person or body as prescribed in such Orders may be subject to restrictions or limitations pursuant to such Orders.

4.51 We do not consider that the mere fact of a Company becoming insolvent (either in the sense of its liabilities exceeding its assets, or in the sense of it being unable to pay its debts) or the commencement of insolvency proceedings (meaning the filing of a winding up petition with the Court in accordance with the Companies Law) would automatically cause the termination of any agency appointment made by or on behalf of a Company under or pursuant to a Covered Base Agreement or a CDA (unless that was a term of the Covered Base Agreement or CDA). However, based on English case law (which would be persuasive but not binding in the Cayman Islands[9]), we believe that the appointment of either an official or provisional liquidator in accordance with the Companies Law will result in the termination of any agency appointment made by or on behalf of a Customer under or pursuant to a Covered Base Agreement and CDA. The termination of any such agency appointment would not affect the enforceability of any validly created termination arrangements exercisable in accordance with the terms of the Covered Base Agreement or CDA or the enforceability of any security interests under the Covered Base Agreement or CDA.

*Customers regulated under Cayman Islands Regulatory Laws*

4.52 The provisions of Cayman Islands regulatory laws providing for the appointment of controllers and liquidators[10] will apply to a Company, a Trustee acting as trustee of a Trust and a Partnership regulated under the relevant regulatory law. In practice, if proceedings are taken under the regulatory laws in respect of a Customer the analysis is the same as for the equivalent non-regulated entity because the effect of the regulatory laws is to apply the principles in the Companies Law[11].

[9] *Pacific and General Motor Insurance v Hazell [1997]BCC 400*

[10] See the discussion in paragraphs 4.54 - 4.55

[11] Under certain of the regulatory laws (e.g. the Mutual Funds Law (2020 Revision) the regulated entity is in fact the Trust and the Partnership notwithstanding that they do not have separate legal personality. We do not believe that the application of the insolvency provisions in the Companies Law to the Trust or the Partnership as such would affect the outcome and the analysis should be the same as for the equivalent unregulated entity as described in this Memorandum.

## 5 Collateral: Fact Patterns

You have asked us, when responding to each question, to distinguish between the following three fact patterns to the extent they affect the answers to any question:

5.1 The Location of the Customer is in the Cayman Islands and the Location of the Collateral is outside the Cayman Islands.

5.2 The Location of the Customer is in the Cayman Islands and the Location of the Collateral is in the Cayman Islands.

5.3 The Location of the Customer is outside the Cayman Islands and the Location of the Collateral is in the Cayman Islands.

5.4 For the foregoing purposes:

5.4.1 the term "Collateral" when used in this Memorandum, is meant to refer to any assets in which a security interest is created by the Customer in favour of the FCM;

5.4.2 the "Location" of the Customer is in the Cayman Islands if it is incorporated or otherwise organised in the Cayman Islands and/or has a branch or other place of business in the Cayman Islands; and

5.4.3 the "Location" of Collateral is the place where an asset of that type is located under the private institutional law rules of the Cayman Islands.

## 6 Collateral: Background Information and Assumptions

In addition to the general assumptions contained in paragraph 3, we further understand and assume that:

6.1 pursuant to the relevant Covered Base Agreement and CDA, the FCM and the Customer agree that Futures Credit Support and Cleared Derivatives Credit Support (**"Collateral"**) will include cash credited to an account (as opposed to physical notes and coins) and certain types of securities (as further described below) that are located or deemed located either (i) in the Cayman Islands, or (ii) outside the Cayman Islands (“**Eligible Collateral**").

6.2 any securities provided as Collateral are denominated in either the currency of the Cayman Islands or any freely convertible currency and consist of (i) corporate debt securities whether or not the issuer is organized or located in the Cayman Islands; (ii) debt securities issued by the government of the Cayman Islands; and (iii) debt securities issued by the government of a member of the “G-10” group of countries, in one of the following forms:

(i) directly held bearer debt securities: by this we mean debt securities issued in certificated form, in bearer form (meaning that ownership is transferable by delivery of possession of the certificate) and, when held by a FCM or a DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or a DCO (that is, not held by the FCM or DCO indirectly with an Intermediary (as defined below));

(ii) directly held registered debt securities: by this we mean debt securities issued in registered form and, when held by a FCM or DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or DCO so that the

FCM or DCO is shown as the relevant holder in the register for such securities (that is, not held by the FCM or DCO indirectly with an Intermediary);

(iii) directly held dematerialized debt securities: by this we mean debt securities issued in dematerialized form and, when held by a FCM or DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or DCO so that the FCM or DCO is shown as the relevant holder in the electronic register for such securities (that is, not held by the FCM or DCO indirectly with an Intermediary);

(iv) intermediated debt securities: by this we mean a form of interest in debt securities recorded in fungible book entry form in an account maintained by a financial intermediary (which could be a central securities depositary (CSD) or a custodian, nominee or other form of financial intermediary, in each case an "**Intermediary**") in the name of the FCM or DCO where such interest has been credited to the account of the FCM or DCO in connection with a transfer of Collateral by the Customer to the FCM under a Covered Base Agreement and CDA;

6.3 the precise nature of the rights of the FCM in relation to its interest in intermediated debt securities and as against its Intermediary will be determined, among other things, by the law of the agreement between the FCM and its Intermediary relating to its account with the Intermediary, as well as the law generally applicable to the Intermediary, and possibly by other considerations arising under the general law or the rules of private international law of your jurisdiction. The FCM's Intermediary may itself hold its interest in the relevant debt securities indirectly with another Intermediary or directly in one of the three forms mentioned in (i), (ii) and (iii). In practice, there is likely to be a number of tiers of Intermediaries between the FCM and the issuer of such securities, at least one of which will be an Intermediary that is a national or international CSD;

6.4 the FCM will normally hold debt securities in the form of intermediated debt securities rather than directly in one of the three forms mentioned in (i), (ii) and (iii);

6.5 due to regulatory requirements, posted Collateral will be held by intermediaries in a way that identifies the Collateral as belonging to customers of the FCM. For example, if the Collateral is held by the FCM or an intermediary of the FCM, that account will show that it is held for customers generally and the FCM's books will show that such Collateral is held for the individual customer. If the posted Collateral is held by the DCO or an intermediary of the DCO, that account will show that it is held for customers generally and, if such Collateral constitutes Cleared Derivatives Credit Support, the DCO's books will show that the Collateral is held for the individual customer;

6.6 cash Collateral is denominated in a freely convertible currency and is held in an account under the control of the FCM or DCO;

6.7 U.S. regulatory requirements impose a duty to segregate customer funds and thereby establish a specific statutory trust over Collateral (including cash Collateral) held by the FCM for the benefit of all its Customers (together with the Futures Payment Rights and the Cleared Derivatives Payment Rights, the "**Trust Assets**"). Because it is not possible to trace any particular funds in the commingled segregated account to any particular Customer, a Customer of an FCM does not have an interest in any particular asset held in segregation, but rather has a fractional interest in the total assets held in segregation;

6.8 as the FCM is the sole counterparty to the contract made on the Customer's behalf with a DCO, it holds legal title to the Futures Transactions and Cleared Derivatives Transactions

credited to such Customer's account on behalf of the Customer. The FCM holds these transactions on an "agent-trust" for the benefit of each Customer. Each Customer will, accordingly, have a beneficial interest in the "agent-trust" over the Futures Transactions and Cleared Derivatives Transactions credited to its specific Customer account. Each "agent-trust" held by the FCM for a Customer will be distinct from all other "agent-trusts" held by the FCM for the benefit of its other Customers;

6.9 the terms of the statutory trust over the segregated funds and each "agent-trust" permit the FCM to deal with the trust property in accordance with relevant legislation and as provided (or implied) in the Customer agreement and entitle the FCM to reimburse itself out of the property for costs and expenses properly incurred in the performance of its agency (in each case, subject to certain statutory limitations). In particular, the FCM is permitted to use the Customer funds credited to a Customer's account to margin, guarantee, secure, transfer, adjust or settle the Customer's transactions, including to pay commissions, brokerage, interest, taxes, storage and other charges relating to the Customer's transactions;

6.10 a Customer's beneficial interest in the statutory trust (which is common to all customers) and its beneficial interest in the "agent-trust" (which is specific to such Customer) is not an interest in any specific asset that constitutes the statutory trust or the "agent-trust" but rather is a beneficial interest in the relevant trust property as a whole (the "**Trust Beneficial Interest**");

6.11 the Customer also grants a security interest over its Trust Beneficial Interest to the FCM. This amounts to creating security over the Customer's beneficial interest under the specific statutory trust in respect of the Collateral in its Customer account and the beneficial interest in the "agent-trust" over the Futures Transactions and Cleared Derivatives Transactions (i.e. the Trust Beneficial Interest) (the "**Trust Security Interest**") as opposed to creating security over the Trust Assets themselves;

6.12 for the purpose of questions in section 7 below, we assume that after entering into the Covered Transactions and prior to the maturity thereof, an Event of Default exists and is continuing with respect to the Customer, and/or the FCM has designated a date to begin exercising its Futures Liquidation Rights or Cleared Derivatives Liquidation Rights (a "**Liquidation Date**") as a result thereof (however, an insolvency proceeding has not been instituted); and

6.13 for the purposes of questions in section 8 below, we assume that a formal bankruptcy, insolvency, liquidation, reorganization, administration or comparable proceeding (collectively, the "**insolvency**") has been instituted by or against the Customer and an Event of Default has accordingly occurred under the Covered Base Agreement and CDA.

## 7 Collateral under a Covered Base Agreement and CDA: Questions

*Consequences of Security Interest*

*Would the security interest granted by the Customer to the FCM be recognized in the Cayman Islands as creating a security interest over the Customer's Trust Beneficial Interest in the form of a Trust Security Interest as set out in assumption 6.10 above or, alternatively, as creating a security interest directly over the Trust Assets themselves in the form of a Collateral Security Interest as described below?*

7.1 Under Cayman Islands law the contractual aspects of a security interest in the various forms of Collateral will be determined by the Governing Law of the relevant Covered Base

Agreement and CDA. If as a matter of the Governing Law of the Consumer Base Agreement and CDA a legal, valid and binding security interest is granted over the Customers Trust Beneficial Interest and over the Trust Assets, then Cayman Islands law would honour and recognize such security interest over the Trust Beneficial Interest.

*In respect of the security interest created, as set out in your answer in 7.1 above, are there any Cayman Islands law consequences of the creation of such security interest that should be considered and may affect the arrangements between the FCM and its customers? In particular, are there any provisions under Cayman Islands law that may render such security interest void (for example, as a result of non-compliance with registration formalities) and therefore cause the money secured by the security interest to become immediately payable?*

7.2 As a general matter no, however please see our responses set out in Sections 7.4 to 7.7 below.

*Under the laws of the Cayman Islands, what law governs the operation of the Trust Security Interest? Would the courts of the Cayman Islands recognize the validity of the Trust Security Interest created under each Covered Base Agreement and CDA assuming it is valid under the Governing Law of the applicable Covered Base Agreement and CDA?*

7.3 Under Cayman Islands law the contractual aspects of a security interest in the various forms of Collateral will be determined by the Governing Law of the relevant Covered Base Agreement and CDA. The Cayman Islands courts would regard a security interest as validly created if the same is true under the Governing Law.

*Under the laws of the Cayman Islands, what law governs the proprietary aspects of the Trust Security Interest (that is, the formalities required to perfect the Trust Security Interest against competing claims) granted by the Customer (for example, the law of the jurisdiction of incorporation or organization of the Customer, the jurisdiction where the Collateral is Located, or the jurisdiction of location of the FCM's Intermediary in relation to Collateral in the form of indirectly held securities)? What factors would be relevant to this question? Where the location (or deemed Location) of the Collateral is the determining factor, please briefly describe the principles governing such determination under Cayman Islands law with respect to the different types of Collateral. If relevant, please describe how the laws of your jurisdiction apply to each form in which securities Collateral may be held as described in assumption* 6.2 above.

7.4 The law which determines the proprietary aspects of the Trust Security Interest created by the relevant Covered Base Agreement and CDA will depend, in part, upon the nature of the Collateral.

7.5 The applicable law for Collateral consisting of tangible moveables, such as bearer debt securities in certificated form, is the *lex situs* which will be the place where the certificate representing the security is located.

7.6 The applicable law for Collateral consisting of intangible moveables is not entirely free from doubt. One view is that the applicable law is the *lex situs*. The alternative view is that the applicable law is the governing law of the security. For the reasons given below, based on English authorities and authoritative legal commentaries, we believe the better view (particularly in relation to intangible movables in the nature of the Collateral) is that the *lex situs* would determine proprietary issues in the case of intangible movables. This view does however require a fictional "situs" to be attributed to intangibles. We believe the following

summary represents the current position in the Cayman Islands in relation to the different types of Collateral.

7.6.1 Directly held registered debt security: the law of the place where the security is properly recoverable or can be enforced[12]. This is likely to be the location of the register as that is where the question of title will be determined[13]. This location will often coincide with the location of the debtor but in cases where it is different the authorities suggest the place where the register is located would prevail.

7.6.2 Directly held dematerialised debt security: the law of the place of the electronic register in which the Customer's interest in the securities is recorded. Although there is no direct authority on this in the Cayman Islands it accords with the theory that intangibles have a "situs" where they are enforceable[14].

7.6.3 Indirectly held debt/equity securities: although there is no authority in the Cayman Islands we believe the situs of an interest in securities recorded in fungible book-entry form in an account of an Intermediary would be where the account is maintained. There is some support for this view in Dicey & Morris[15] and it is supported by many of the leading commentators[16] (in relation to English law which would be regarded as persuasive).

7.6.4 Collateral in the form of cash deposited with a bank will be located where the bank is located (or the location of the bank branch with which the deposit is made).

7.6.5 Collateral in the form of general Intangibles and contract rights: the law of the place in which the rights are properly recoverable or can be enforced. This will depend upon the facts and circumstances but is usually where the obligor or debtor in respect of the relevant claim is located. The location of the obligor or debtor is not necessarily the place of its head office or registered office. For example, if the obligor or debtor incurs the relevant obligation through a branch it is likely to be where the branch is located.[17]

7.7 As noted above the alternative view is that the governing law of an intangible movable should apply to determine the proprietary aspects of the creation of a security interest. Whilst certain older authorities dealing with simple chose in action seem to support this view it is arguable that such a view may not be appropriate for all types of intangible movables such as financial securities which may be registered, evidenced by pieces of paper or represent indirect interests in underlying assets held and dealt with through electronic systems using tiers of intermediaries. It has also been suggested that, at least in relation to financial intangibles, *MacMillan v Bishopsgate*[18] supports the view that the *lex situs* approach applies to intangible movables as well as tangible movables. In many cases, even if the governing law approach does apply, it would point to the same law as the *lex situs* approach. For example, in the case of indirectly held debt securities, the law governing the account between the Customer and its closest intermediary will very often be the same as the law of the place where the account is maintained.

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[12] *Dicey & Morris on the Conflict of Laws*, 15th Edition Vol II Rule 129(1).

[13] *Alcock v Smith* [1892] I Ch 238.

[14] The view finds some support in *Dicey & Morris*, 15th Edition, Vol II, para 22-043.

[15] See *Dicey & Morris*, 15th Edition, Vol II, para 22-043 and 24-071.

[16] See Dr Joanna Benjamin, *Interests in Securities*, para 7.34.

[17] See *Dicey & Morris* 15th Edition, Volume II, Rule 129(1).

[18] *MacMillan Inc v Bishopsgate Investment Trust plc* (No.3) [1995] 3 ALL ER 747.

*Assuming that the courts of the Cayman Islands would recognise the Trust Security Interest, is any action (filing, registration, notification, stamping, notarisation or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) required in the Cayman Islands to perfect the Trust Security Interest? If so, please indicate what actions must be taken and how such actions may differ, if at all, depending on the type of Collateral which is subject to the Trust Security Interest*.

7.8 The steps required to be taken in the Cayman Islands to perfect the Trust Security Interest in the Cayman Islands depend upon a number of factors including whether the Customer is established in the Cayman Islands (and, if it is, whether it is a Company, a Partnership or a Trustee acting as trustee of a Trust), the location of the Collateral and the type of security interest created by the Covered Base Agreement and the CDA.

7.9 If the Customer is a Company the Customer is required to record the Trust Security Interest created in its Register of Mortgages and Charges kept at its registered office in the Cayman Islands. This recording need only be made once and should show a short description of the property mortgaged or charged (or otherwise subject to the Trust Security Interest), the amount of the charge created (or if, as in the case of the Covered Base Agreement and CDA, this is not a fixed amount, a description of the amount secured by the Trust Security Interest) and the names of the mortgagees or persons entitled to the charge. Failure to make entries in the Register does not, however, affect the perfection or priority of the security interest but merely exposes the Customer and its directors to fines. However, we recommend that the entry be made so that any subsequent encumbrancer or purchaser that chooses to inspect the Customer's Register of Mortgages and Charges will become aware of the existence of the Trust Security Interest (this may be relevant to perfection or priority issues if under the applicable law which determines those issues notice of a prior encumbrance affects priority).

7.10 A Partnership is not required to keep a similar register and we believe that a general partner of an exempted limited liability partnership which is a company incorporated under the Companies Law would not be required to make an entry in its register in respect of a security interest created in assets held by it on trust as partnership assets for the partnership because the security would be created by it as general partner of the partnership[19] rather than over assets which it holds beneficially. In the case of a limited partnership or an unlimited partnership established under the Partnership Law the position may be difficult because the partners hold the assets jointly. A Trustee of a Trust would not be required to record in its register a security interest in respect of assets held by it as trust assets because again (usually) the security interest would not be over assets held by the Trustee beneficially.

7.11 As mentioned above, it would be necessary to pay Cayman Islands stamp duty if the Covered Base Agreement and CDA is executed in or, having been executed abroad, the original (or a duplicate original) comes into the Cayman Islands (for example, for the purposes of enforcement).

7.12 If Cayman Islands law determines perfection (that is, how to make a security interest of a particular type good against third parties subject to any priority rules[20]), the steps required to perfect the Trust Security Interest will depend upon a number of factors including the nature of the security interest created[21] and the nature of the Collateral. Dealing with the types of Collateral:

[19] See section 6(2) of the Exempted Limited Partnership Law.

[20] For a discussion of the priority rules, see the answer to question 16.

[21] Different perfection rules will apply to legal and equitable security interests.

7.12.1 directly held bearer debt securities: perfection usually requires the delivery and possession of the certificates representing the security;

7.12.2 directly held registered debt securities: equitable security is perfected by giving notice to the obligor under the rule in *Dearle v Hall*[22]. A legal security interest is perfected by transferring legal title to the FCM which will usually require appropriate entries being made in the register relating to the securities;

7.12.3 directly held dematerialised debt securities: equitable security is perfected by notice to the account holder. Legal security requires the FCM to be recorded as the relevant holder in the electronic register for such securities;

7.12.4 indirectly held debt securities: the nature of the rights of the FCM in relation to an interest in indirectly held securities will depend upon the nature of the relationship between the Customer and the FCM and the Intermediary. That interest may be equitable in nature. Equitable security requires notice to be given to the Intermediary under the rule in *Dearle v Hall*. If the interest in the securities is required to be transferred under the Covered Base Agreement and CDA, the FCM must be registered as the holder in the book-entry system; and

7.12.5 security interests over general choses in action such as rights in contracts are perfected by notice to the obligor with respect to such rights under the rule in *Dearle v Hall*. Security interests over limited partnership interests in Exempted Limited Partnerships are perfected by serving written notice at the registered office of the Exempted Limited Partnership in accordance with the Exempted Limited Partnership Law and subject to any terms of the applicable exempted limited partnership agreement. The general partner is required to keep a register of security interests of limited partnership interests. The Exempted Limited Partnership Law provides for the security interest of a limited partnership interest to have priority according to the date of service of written notice at the registered office.[23]

*If there are any other requirements to ensure the validity or perfection of the Trust Security Interest, please indicate the nature of such requirements. Are there any other documentary formalities that must be observed in order for the Trust Security Interest to be recognised as valid and perfected in the Cayman Islands?*

7.13 There are no other documentary or formal steps required to ensure the validity and perfection of the Trust Security Interest contemplated in this Memorandum. It is not necessary as a matter of formal validity that the Covered Base Agreement or CDA be governed by Cayman Islands law, be translated into any other language or contain any specific language (provided they evidence an intention to create the Trust Security Interest). Cayman Islands stamp duty will be payable if the Covered Base Agreement and CDA are executed in or, after execution abroad, an original (or a duplicate original) comes into the Cayman Islands (for example, for the purpose of enforcement).

*Assuming that the FCM has obtained a valid and perfected Trust Security Interest under the laws of the Cayman Islands, to the extent such laws apply, by complying with the requirements set forth in our responses to the questions above, as applicable, will the FCM or the Customer need to take any action thereafter to ensure that the Trust Security Interest continues and/or remains perfected, particularly with respect to additional Collateral*

[22] *Dearle v Hall* (1828) 3 Russ 1.

[23] Exempted Limited Partnership Law, Section 31(4)

*transferred from time to time when required pursuant to the Covered Base Agreement and CDA?*

7.14 There are no additional actions which the FCM or the Customer should take to ensure the Trust Security Interest continues and/or remains perfected. The necessary steps required under the applicable law(s) to take a perfected security interest in additional Collateral pledged under the Covered Base Agreement and CDA will need to be taken, however, as and when additional Collateral is transferred.

*Are there any particular duties, obligations or limitations imposed on the FCM as the FCM in relation to the care of the Collateral held by it pursuant to the Trust Security Interest?*

*7.15* Apart from obligations, duties or limitations imposed under the terms of the relevant Covered Base Agreement and CDA or under general New York law or other relevant local law(s) where the Collateral may be held by the FCM, there are no particular duties, obligations or limitations. Under Cayman Islands law, to the extent it is applicable, the FCM must take reasonable steps to ensure the safe custody of any Collateral in its possession.

*The terms of a Covered Base Agreement and CDA may grant the FCM broad rights with respect to the use of Collateral that constitutes Futures Credit Support and Cleared Derivatives Credit Support and is subject to the Trust Security Interest. Additionally, the Covered Base Agreement and CDA are subject to the rules of DCOs, which may also grant DCOs similar rights with respect to the use of Collateral that has been on-posted from a FCM to a DCO. Such use by the FCM and the DCO might include investing cash posted by the Covered Customer (or on-posted by the FCM to the DCO) in certain types of investments permitted by the CFTC, pledging or rehypothecating the securities pledged by the customer (or repledged by the FCM to the DCO), disposing of the securities under a securities repurchase (repo) agreement or selling securities.*

*Such rights of use are, though, subject to the CFTC's customer funds segregation rules, which require that customer funds (including any assets resulting from the investment of customer funds and the cash received from rehypothecating or disposing of securities) must be separately accounted for by each of the FCM and DCO, must not be commingled with its own funds, must be held for the benefit of customers and treated as belonging to customers and must be calculated so as to prevent the use of one customer's funds to margin or secure another customer's positions. However, while CFTC rules generally prohibit the commingling of a customer's funds with those of the FCM or any other person, the rules also permit a customer's funds to be commingled with those of other customers of the FCM in segregated customer omnibus accounts and require the FCM to keep its own funds in such segregated omnibus accounts to serve as a cushion in the event of an unexpected shortfall. CFTC rules also permit each of the FCM and a DCO to receive and retain as its own any incremental income or interest income resulting from the investment of customer funds in permitted investments.*

*Do the laws of the Cayman Islands recognize the right of the FCM or DCO so to use such Collateral pursuant to an agreement with the Customer? In particular, how does such use of the Collateral affect, if at all, the validity, continuity, perfection or priority of the Trust Security Interest otherwise validly created and perfected prior to such use? Are there any other obligations, duties or limitations imposed on the FCM or DCO with respect to its use of the Collateral under the laws of the Cayman Islands? In considering the above question in relation to a DCO, please limit your response to the extent that rights or duties applicable to the DCO under the laws of the Cayman Islands are relevant to the validity, continuity, perfection or priority of FCM's Trust Security Interest.*

7.16 Cayman Islands law will recognise a right of the FCM and DCO to use the collateral pursuant to the terms agreed in the Covered Base Agreement and the CDA assuming this is effective as a matter of New York law. The effect of such use on the validity, continuity, perfection or priority of the Trust Security Interest otherwise validly created and perfected prior to such use depends upon New York law as the law governing the Covered Base Agreement and the CDA and the law which, as a matter of Cayman Islands law, determines proprietary issues.

7.17 If Cayman Islands law is applicable to these issues, for example, because the Collateral is located in the Cayman Islands, the right of the FCM or DCO to use the Collateral either by way of outright transfer of a legal interest or the creation of an equitable interest in favour of a third party may be inconsistent with the creation of a security interest and accordingly the contractual right of the FCM or DCO to use the Collateral may be ineffective (this may not affect the rights of any third party however whose entitlement to the Collateral should be determined on the basis of the rules outlined above).

7.18 The right of the FCM or DCO to use the Collateral may also constitute a restriction on the equity of redemption as it would prevent the Customer getting back the Collateral on discharge of the secured obligation (and as such it could therefore be invalid under the rule which prohibits "clogs on the equity of redemption"). We believe the effect of such a rule is only to invalidate the restriction (i.e., the right to use) and not to render the Covered Base Agreement and CDA void. Furthermore, this may not be an issue where the Customer may already have no right to get back his specific Collateral, for example, where the security is over interests recorded in fungible book-entry form.

*What is the effect, if any, under the laws of the Cayman Islands on the validity, continuity, perfection or priority of a security interest in Collateral under each Covered Base Agreement and CDA of the right of the Customer to substitute Collateral by transferring additional Collateral to an Account or Cleared Derivatives Account and withdrawing excess Collateral from that Account or Cleared Derivatives Account? Please comment specifically on whether the Customer and the FCM are able validly to agree in the Covered Base Agreement and CDA that the Customer may substitute Collateral without specific consent of the FCM and whether and, if so, how this may affect the nature of the security interest or otherwise affect your conclusions regarding the validity or enforceability of the security interest.*

7.19 The effect on the validity, continuity, perfection and/or priority of a security interest in the Collateral of the right of the Customer to substitute collateral will depend upon the terms of the relevant Covered Base Agreement and CDA and the law which, as a matter of Cayman Islands law, determines proprietary issues. Whilst Cayman Islands law would not prevent or restrict the Customer and the FCMs from agreeing as a matter of contract in the Covered Base Agreement and CDA the terms of any substitution of Collateral, the validity of such terms would be determined in accordance with the governing law of the applicable Covered Base Agreement and CDA.

7.20 The substitution of Collateral raises the question whether the security interest may be regarded as a floating rather than a fixed charge. Cayman Islands law distinguishes between fixed security and floating security. The recognition of the security as fixed or floating as a matter of Cayman Islands law is only likely to be relevant in the context of claims by preferential creditors where the Customer is a Company, Partnership or Trustee unless the Collateral is situated in the Cayman Islands in which case, based on the principles discussed above, Cayman Islands law would also determine the priority of the floating charge as against other creditors. English case law (which is persuasive in the Cayman

Islands) would be followed in terms of determining the key characteristics and nature of a floating charge[24].

7.21 A FCM holding a fixed charge will, notwithstanding that a winding up order has been made, be entitled to enforce his security without the leave of the Court and without reference to the liquidator. However, if the security created by the relevant Covered Base Agreement and CDA is treated as a floating charge the following consequences arise:

7.21.1 Debts preferred under Cayman Islands law will have priority over the FCM on a liquidation of the Customer which is a Company (in proceedings under the Companies Law) or a Partnership (in proceedings against a Cayman Islands partnership under the Bankruptcy Law (1997 Revision) (the "**Bankruptcy Law**")[25]. In practice preferred creditors should have little impact on the claims of other creditors given the nature of the preferred debts as set out below.

(a) Preferred debts on a winding up of a Company are as follows[26]:

(i) any sum due by the Company to an employee, whether employed in the Cayman Islands or elsewhere in respect of salaries, wages and gratuities accrued during the four months immediately preceding the liquidation;

(ii) any sum due and payable by the Company on behalf of an employee in respect of medical health insurance or pension fund contributions;

(iii) any sum due in respect of severance pay and earned vacation leave where the employee's contract has been terminated as a result of the winding up;

(iv) any compensation payable to a workman in respect of injuries incurred at work pursuant to the Workmen's Compensation Law (1996 Revision);

(v) certain taxes due to the Cayman Islands Government comprising customs duties, stamp duty, licence fees, sums payable under the Companies Law (2020 Revision) such as annual return fees, sums payable under the Tourist Accommodation (Taxation) Law (2013 Revision); and

(vi) depositors (with deposits of CI$20,000 (US$24,390) or less) with a bank incorporated in the Cayman Islands (a "Bank") which holds a Category "A" License issued under the Banks and Trust Companies Law (2020 Revision) (the "**Banks and Trust Companies Law**")[27].

[24] These being (i) is it a charge on a class of assets, present and future; (ii) the class is one which in the ordinary course of business is changing from time to time; and (iii) is it contemplated by the charge that until some step is taken by or on behalf of those interested in the charge, the chargor may carry on its business in the ordinary way so far as concerns that class of assets.

[25] Preferred creditors are also relevant in the case of a Trustee which is a company incorporated under the Companies Law but as any trust assets should not form part of the Trustee's personal estate on the Trustee's insolvency, the Trustee's preferential creditors should only share in the Trustee's personal assets (which may include the right to be reimbursed or indemnified out of the Trust Assets).

[26] These debts rank *pari passu* among themselves and the list in (i)-(vi) below is not a list of the order of priority of payment.

[27] Certain categories of depositors are excluded from preferential treatment, for example, other banks licensed in the Cayman Islands, foreign licenced banks holding deposits on behalf of third parties or deposit holders and persons owning legally or

(b) Preferred creditors in relation to proceedings under the Bankruptcy Law are creditors in respect of the following items[28]:

(i) all public taxes imposed by law due from the debtor at the date of the provisional order not exceeding in the whole one year's taxes;

(ii) all wages or salary of any clerk or servant in respect of services rendered to the debtor during four months next preceding the date of the provisional order, not exceeding CI$100; and

(iii) all wages of any labourer or workman in respect of services rendered to the debtor during four months next preceding the date of the provisional order.

(c) Under Section 40(2) of the Labour Law (2011 Revision), liability for severance pay (consisting of one week's wages, at the employee's latest basic wage, for each completed twelve month period of his employment with his employer and any predecessor-employer) also has priority over all other debts. It should also be noted that claims in respect of severance pay pursuant to section 40(2) of the Labour Law (2011 Revision) also have priority over claims of creditors with fixed or floating security. Section 65(3) of the National Pensions Law (2012 Revision) provides that in any case, where on the application of a secured creditor the property of an employer is sold, the proceeds of the sale of the property may not be distributed to any person entitled to them until the Court ordering the sale has made provision for the payment into a pension fund of any amount due in respect of both contributions payable by the employer and employees' contributions deducted from the payroll but not credited to the pension fund. This provision appears to give priority to claims in respect of unpaid pension contributions over the claims of creditors with fixed or floating security.

7.21.2 Subsequent purchasers, mortgagees, chargees, lienholders and execution creditors in respect of the assets subject to the floating charge are likely to have priority over the Secured Party although this will depend upon such factors as the terms of the floating charge, in particular the scope of any restrictions, whether any subsequent purchasers, mortgagees or chargees have knowledge of any restrictions and the circumstances in which any subsequent transactions arise. As this issue relates to questions of priority it will only be relevant if under the conflict of law rules discussed previously the priority of competing interests in the Collateral is to be determined under Cayman Islands law.

7.22 Although there is no authority on the point in the Cayman Islands, it is arguable that the right of substitution without the consent of the FCM is not by itself sufficient to constitute the security created by the relevant Covered Base Agreement and CDA as a floating charge because although the Customer may have the right to substitute security it does not have a general right to deal with assets subject to the security interest without providing substitute Collateral. There is however a risk that such an arrangement may be recharacterised as a floating charge because of the Customer's ability to get back Collateral of its own choosing and therefore to direct the use of the Collateral.

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beneficially 5% or more of the shares of all classes issued by the Bank. The amount of any deposit must be reduced by any liability owed by the depositor to the Bank in respect of which a right of set-off existed at the date of the petition of the winding up.

[28] These debts rank *pari passu* among themselves and the list in (i)-(iii) below is not a list of the order of priority of payment.

7.23 If the FCM must consent to the substitution we believe it is clear that the right of substitution would not result in the security interest created constituting a floating charge (provided that as a matter of practice the consent is actually given and such consent was genuine).

7.24 The substitution of Collateral could constitute a fraudulent preference in certain circumstances (as discussed below).

## 8 Exercise of Enforcement of Liquidation Rights in the Absence of an Insolvency Proceeding

*Assuming that the FCM has obtained a valid and perfected Trust Security Interest under the laws of the Cayman Islands, to the extent such laws apply, by complying with all responses to the questions above, as applicable, what are the formalities (including the necessity to obtain a court order or conduct an auction), notification requirements (to the Customer or any other person) or other procedures, if any, that the FCM must observe or undertake in exercising its Enforcement Liquidation Rights (including the operation of the Determination of Account) as a FCM under each Covered Base Agreement and CDA? For example, is it free to sell the Collateral (including to itself) and apply the proceeds to satisfy the Customer's outstanding obligations under the Covered Base Agreement and CDA? Do such formalities or procedures differ depending on the type of Collateral involved?*

8.1 There are no formalities, notification requirements or other procedures that the FCM must observe or undertake in the Cayman Islands in exercising its rights as FCM under the relevant Covered Base Agreement and CDA (other than those which may be provided for under the terms of the relevant Covered Base Agreement and CDA) assuming the same is true as a matter of the Governing Law of the Covered Base Agreement and CDA.

8.2 We would note that to the extent the Collateral is situated in the Cayman Islands (and possibly where the FCM is located in the Cayman Islands), we believe that foreclosure in the Cayman Islands (that is, where the Customer's right to redeem the Collateral is extinguished or destroyed and the FCM is left as the owner) would require the consent of the court in the Cayman Islands. We believe a sale by the FCM to itself or an affiliate would be treated as an effective foreclosure and therefore require the consent of the court (assuming Cayman Islands law is applicable).

*Are there any laws or regulations in the Cayman Islands that would limit or distinguish a creditor's enforcement rights with respect to the Trust Security Interest depending on (a) the type of transaction underlying the creditor's exposure, (b) the type of Collateral or (c) the nature of the creditor or the debtor? For example, are there any types of "statutory liens" that would be deemed to take precedence over a Trust Security Interest?*

8.3 Subject to Section 8.2, there are no laws or regulations in the Cayman Islands that would limit or distinguish a creditor's enforcement rights with respect to different types of collateral of the kind comprised in the Collateral. Subject to any debts preferred by law (as discussed above), Section 142(1) of the Companies Law and Section 36(4) of the Exempted Limited Partnership Law allows a creditor who has security over the whole or part of the assets of a Company or Exempted Limited Partnership to enforce his security without the leave of the Court and without reference to the liquidator, notwithstanding that a winding up order has been made and irrespective of the type of collateral secured. However, we would refer you to the discussion below in respect of collateral which includes shares in a Cayman Islands Company where a winding up order has been made in respect of such Company.

8.4 We would also point out that certain preferential creditors and other claims have priority over secured creditors with floating charges and, in certain exceptional cases, fixed and floating charges (see the answer to the question above).

*How would your response to the questions above differ, if at all, assuming that an insolvency proceeding has occurred with respect to the FCM rather than or in addition to the Customer (for example, would this affect this ability of the FCM to exercise its Enforcement Liquidation Rights or the operation of the Determination of Account)?*

8.5 If an insolvency proceeding is subsisting in relation to the FCM rather than the Customer, the question whether the FCM will be able to exercise its enforcement rights if there is also an insolvency proceeding subsisting in relation to the Customer, will be determined by New York law as the governing law of the Covered Based Agreement and CDA and the insolvency laws applicable to the FCM.

*Assuming that (a) pursuant to the laws of the Cayman Islands, the laws of another jurisdiction govern the creation and/or perfection of a security interest in the Collateral transferred by way of security pursuant to each Covered Base Agreement and CDA (for example, because such Collateral is located or deemed to be located outside the Cayman Islands) and (b) the FCM has obtained a valid and perfected security interest in the Collateral under the laws of such other jurisdiction, are there any formalities, notification requirements or other procedures, if any, that the FCM must observe or undertake in the Cayman Islands in exercising its rights as a FCM under each Covered Base Agreement and CDA?*

8.6 No, assuming that the FCM is not located in or carrying out business in the Cayman Islands.

9 **Exercise of Enforcement Liquidation Rights by the FCM after the Commencement of an Insolvency Proceeding**

*How are competing priorities between creditors determined in the Cayman Islands? What conditions must be satisfied if the FCM's Trust Security Interest is to have priority over all other claims (secured or unsecured) of an interest in the Collateral, other than claims of a DCO?*

9.1 Cayman Islands conflict of law rules will determine the law applicable to priority issues. These rules are considered above.

9.2 If Cayman Islands law is the applicable law, the general principles are:

9.2.1 secured creditors rank ahead of unsecured creditors[29];

9.2.2 a legal interest acquired for value and without notice overrides prior equitable interests;

9.2.3 as between competing equitable interests, the first in time prevails;

9.2.4 in relation to debts (and by extension all chose in action) priority is determined (even as against a bona fide purchaser of a legal interest without notice) on the basis of the first to give notice to the debtor (the rule in *Dearle v Hall*). In relation to a chose in action in the form of limited partnership interests, priority is determined according to the time that written notice is validly served at the registered office of the Exempted

[29] Subject to the statutory exceptions already considered.

Limited Partnership in accordance with section 32(9) of the Exempted Limited Partnership Law; and

9.2.5 if insolvency proceedings are commenced in the Cayman Islands certain preferential creditors will have priority over floating charges and, in certain cases, fixed charges, as indicated above.

*Would the FCM's right to exercise its Enforcement Liquidation Rights (including the operation of the Determination of Account) be subject to any stay or freeze or otherwise be affected by commencement of the insolvency (that is, how does the institution of an insolvency proceeding change your responses to the questions above, if at all)?*

9.3 The FCM's rights under each Covered Base Agreement and CDA would not be subject to any stay or freeze or otherwise be affected by the commencement of the insolvency or winding up of the Customer.

9.4 Where the Customer is a Company, Section 97(1) of the Companies Law provides:

"When a winding up order is made or a provisional liquidator is appointed, no suit, action or other proceedings, including criminal proceedings, shall be proceeded with or commenced against the company except with the leave of the Court and subject to such terms as the Court may impose."

This prohibition in our view extends to judicial proceedings and does not include security enforcement methods which do not require an order of the court in the Cayman Islands. Furthermore, subject to any debts preferred by law as discussed above, Section 142 of the Companies Law and Section 36(4) of the Exempted Limited Partnership Law provides that secured creditors may enforce their security notwithstanding that a winding up order has been made in respect of the Customer that is a Company or Exempted Limited Partnership.

It should also be noted that Section 96 of the Companies Law provides that, at any time after the presentation of a winding up petition and before a winding up order has been made, the Company or any creditor or contributory may (a) where any action or proceeding against the Company, including a criminal proceeding, is pending in a summary court, the Court, the Court of Appeal or the Privy Council, apply to the court in which the action or proceeding is pending for a stay of proceedings therein, and (b) where any action or proceeding is pending against the Company in a foreign court, apply to the Court for an injunction to restrain further proceedings therein, and the court to which application is made may, as the case may be, stay or restrain the proceedings accordingly on such terms as it thinks fit.

In practice the scope and effect of the stay under Section 96 is the same as Section 97(1) and therefore, similarly, the prohibition, in our view will only extend to judicial proceedings and not security enforcement methods. On a voluntary winding up there is no automatic moratorium. The Court does however have discretion to impose a moratorium on a blanket or a case by case basis. In practice, the court would only exercise its discretion if there was any doubt about the Company's solvency and, in our view, this moratorium should not prevent a secured creditor from enforcing its security.

9.5 Where the Customer is a Partnership and proceedings are taken under the Bankruptcy Law, Section 34 provides that when a provisional or an absolute order has been made against a debtor, no creditor shall have any remedy against the property or person of the debtor and all proceedings shall be stayed. It is expressly provided, however, that the provisions of Section 34 shall not affect the power of any secured creditor to realise or otherwise deal with his security in the same manner as he would have been entitled to realise or deal with the same

if Section 34 had not been passed. We believe that proceedings under the Bankruptcy Law would not therefore prevent the FCM from enforcing its security against a Partnership.

9.6 The institution of insolvency proceedings would not otherwise affect our replies to the questions addressed in 8.1 and 8.2 above.

*Will the Customer (or its administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official) be able to recover any transfers of Collateral made to the FCM during a certain "suspect period" preceding the date of the insolvency as a result of such transfer constituting a "preference" (however called and whether or not fraudulent) in favour of the FCM on any other basis? If so, how long before the insolvency does this suspect period begin? If such a period exists, would the substitution of Collateral by the Customer during this period invalidate an otherwise valid Trust Security Interest if the substitute Collateral constituting Credit Support is of no greater value than the assets it is replacing? Would the posting of additional Collateral (an amount that reflects a change in the mark-to market value of one of more Covered Transactions) pursuant to the mark-to-market provisions of the Covered Base Agreement and CDA during the suspect period be subject to avoidance, either because the Collateral was considered to relate to an antecedent or pre-existing obligation or for some other reason?*

*Where the Customer is a Company or Exempted Limited Partnership*

9.7 The following paragraphs discuss avoidance provisions applicable to Companies and, in certain respects, Exempted Limited Partnerships. These rules will also be relevant to Trustees and to Partnerships to the extent the Trustee or the General Partner is a Company incorporated in the Cayman Islands.

*Voidable preference*

9.8 Any transfer of Collateral by a Customer which is a Company may, in certain circumstances, be invalid if the pre-conditions for a voidable preference under Section 145(1) of the Companies Law were present. In accordance with Section 145(1), every conveyance or transfer of property or charge therein, every payment, every obligation and every judicial proceeding made, incurred, taken or suffered by any Company or Exempted Limited Partnership which is unable to pay its debts as they become due from its own monies in favour of any creditor (the FCM) with a view to giving such creditor a preference over the other creditors will be invalid if made within, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation of the Customer. Cayman Islands law provides that there must be a dominant intention to prefer the creditor. If the Company's or Exempted Limited Partnership's primary purpose in entering into the transaction was to achieve something other than preferring a creditor, then it should not be a voidable preference, even if preferring that creditor was a collateral effect of that payment. Furthermore, in accordance with Section 145(2) and for the purposes of Section 145(1), if any such payment was made to a related party of the Company, such payment shall automatically be deemed to have been made with a view to giving such creditor a preference. For this purpose, a creditor shall be treated as a "related party" if it has the ability to control the Company or exercise significant influence over the Company in making financial and operating decisions. Sections 145 (1) and (2) shall only apply to Exempted Limited Partnerships upon an involuntary winding up or dissolution of such Exempted Limited Partnership.

9.9 Where the Collateral is transferred during the suspect period in substitution for other Collateral and the substitute Collateral is of no greater value than the Collateral it is

replacing, Section 145(1) of the Companies Law could technically apply but it may be difficult to show in practice that the Customer had a dominant intention to prefer one creditor over another.

9.10 The posting of "mark-to-market" Collateral during the suspect period at a time when the Customer is insolvent could be void under Section 145(1) although it may be argued that as the Collateral is provided pursuant to a pre-existing contractual obligation to provide further security and not by the Customer with a view to preferring one creditor over another, the Customer does not have an intention to prefer the FCM over other creditors. Also, it is possible that in any given circumstance, the security may be provided for new monies (and therefore not by way of preference) although we recognise this may not always be the case. Notwithstanding these arguments it is possible to conceive of a situation where an intention to prefer may exist, for example, if the Customer is required to provide Collateral under two separate Covered Base Agreements and CDA with different counterparties and chooses to do so in relation only to one. However, even in such a case, it would still be necessary to show that the Customer provided Collateral under one Covered Base Agreement and CDA with a dominant intention to prefer that creditor over another and, absent specific facts, this is likely to be difficult to demonstrate.

*Avoidance of dispositions made at an undervalue*

9.11 In accordance with Section 146(2) of the Companies Law, every disposition of property, including any transfer of Collateral, made at an undervalue by or on behalf of a Company or Exempted Limited Partnership with intent to defraud its creditors shall be voidable at the instance of its official liquidator. The burden of establishing an intent to defraud for the purposes of section 146 (2) shall be upon the official liquidator. The liquidator cannot commence an action more than six years after the date of the relevant disposition. See the comments made below in respect of transactions in fraud of creditors.

*Fraudulent trading*

9.12 If in the course of the winding up of a Company it appears that any business of the Company has been carried on with intent to defraud creditors of the Company or creditors of any other person or for any fraudulent purpose the liquidator may apply to the Court for a declaration under Section 147(1) of the Companies Law. Section 147 shall only apply to Exempted Limited Partnerships upon an involuntary winding up or dissolution of such Exempted Limited Partnership.

9.13 For the purposed or sections 146 and 147 of the Companies Act, "intent to defraud creditors" is defined as an intention to wilfully defeat an obligation owed to a creditor.

*Void dispositions*

9.14 Section 99 of the Companies Law provides, *inter alia*, that when a winding up order has been made in respect of a Company of Exempted Limited Partnership, any disposition of the Company's or Exempted Limited Partnership's property and any transfer of shares or alteration in the status of the Company's members made after the commencement of the winding up is, unless the Court otherwise orders, void. We believe that the only circumstances in which this provision could have any application in this case would be if (i) following the commencement of the winding up of the Company or Exempted Limited Partnership, the Customer being a Cayman Islands Company, provided further Collateral under mark-to-market provisions of the Covered Base Agreement and CDA; (ii) attempted to substitute Collateral; or (iii) the Collateral includes shares in a Cayman Islands Company

where a winding up order has been made in respect of such Company or Exempted Limited Partnership in so far as having legal title to the Collateral consisting of such shares transferred.

*Anti-deprivation principle*

9.15 The anti-deprivation principle is a common law rule which provides that an agreement that assets are to belong to a company until its insolvency, but are then to be taken away from the insolvent estate will be invalid as a matter of public policy[30]. The anti-deprivation principle is aimed at attempts to withdraw an asset on liquidation, thereby reducing the value of the insolvent estate to the detriment of creditors. Similar considerations may apply to those for void dispositions set out above.

*Disclaimer and other avoidance issues*

9.16 The liquidator of an insolvent company in the Cayman Islands has no statutory or common law right to disclaim onerous contracts – there is no equivalent statutory provision to the English statutory right of disclaimer under Cayman Islands law. As a general rule, contracts are not automatically terminated by the liquidation of a Company. The liquidator succeeds to all the rights and obligations of the insolvent party and is not generally entitled to avoid[31] obligations or other contractual consequences arising as a result of the liquidation.

*Scheme of arrangement*

9.17 It should also be noted that a creditor of a Cayman Islands Company may have a compromise or arrangement imposed upon him under Section 86(1) of the Companies Law if a majority in number representing three fourths in value of the creditors (or class of creditors including the affected creditor) have approved the compromise or arrangement and it has been sanctioned by the Grand Court of the Cayman Islands. Although this is not a mandatory insolvency provision in the sense of the provisions discussed above, it is a circumstance in which a creditor of a Cayman Islands Company may be made subject to an arrangement or compromise affecting his rights without his consent. It would not, however, affect the enforcement of security rights.

*Where the Customer is a Partnership*

9.18 If the Customer is a Partnership and proceedings are taken against the Partnership in the partnership name under the Bankruptcy Law we believe the substantive provisions of the Bankruptcy Law relating to insolvency would apply. In relation to Exempted Limited Partnerships, the provisions discussed above in relation to the Companies Law shall instead apply.

*Fraudulent preference*

9.19 Section 111(1) of the Bankruptcy Law makes void any fraudulent preference (in terms similar to voidable preferences under Section 145(1) of the Companies Law except that it applies

[30] See, for example, the decision of the English Supreme Court in *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited, Lehman Brothers Special Financing Inc* [2011] UKSC 38. This decision will be persuasive but not binding on the Cayman Islands Courts.

[31] A liquidator may be able to avoid obligations if any statutory or common law rules apply because of the insolvency or the winding up, for example, fraudulent preference rules (as discussed above), or common law rules against forfeiture or principles of corporate benefit. Further, where a contractual provision was not intended to apply in liquidation it may not bind the liquidator and, pursuant to the rule in *ex parte James*, a liquidator may not be able to rely on a contractual provision where it would be unfair on creditors for him to do so.

when the relevant step is made, incurred, taken or suffered within six months before the provisional order takes effect (and in respect of which similar issues arise to those discussed above)). Furthermore Section 107(1) of the Bankruptcy Law makes void any settlement (which means a conveyance, gift or transfer of property) made within two years before a provisional order takes effect except where, *inter alia*, the settlement is made in favour of a purchaser or incumbrancer in good faith and for valuable consideration. It should be noted that a provisional order is deemed to have effect from the first "act of bankruptcy" committed by the debtor within six months preceding the date of presentation of the bankruptcy petition (provided at that time the debtor was indebted to a creditor(s) in an amount sufficient to support a petition (CI$40 (approx. US$49)) and such debt or debts were still outstanding at the date of the provisional order). The effect of a provisional order is to vest all the bankrupt's property in a trustee in bankruptcy with the result that any disposition made by the partnership from the first act of bankruptcy is void. However, Section 118 of the Bankruptcy Law will validate certain transactions (including the payment of debtors, conveyance of property and grant of security) occurring prior to the filing of the petition but after the first act of bankruptcy provided the other party had no notice of any act of bankruptcy which could have formed the basis of a petition at the time the petition was filed. Any act of bankruptcy must have occurred within six months of the presentation of the petition to form the basis of that petition. The possible acts of bankruptcy are set out in Section 14 of the Bankruptcy Law.

*Disclaimer*

9.20 Sections 105 and 106 of the Bankruptcy Law allow a trustee in bankruptcy to disclaim (*inter alia*) onerous contracts (although not parts of the same contract). Onerous contracts include leases burdened with onerous covenants, unmarketable shares, unprofitable contracts or any other property that is unsaleable, or not readily saleable by reason of it binding the possessor thereof to the performance of any onerous act or to the payment of any sum of money. There is no Cayman Islands authority on the meaning of "onerous contracts" for these purposes but we believe the interpretation of the equivalent provision in the English Insolvency Act 1986 would be regarded as persuasive, although not binding, by the courts in the Cayman Islands. In general terms assets are onerous where they are subject to a liability restriction or constraint – the onerous aspect does not necessarily have to impose a positive obligation but can be negative in character. Notwithstanding this provision, a secured creditor is entitled to realise or otherwise deal with its security as if a provisional or absolute order in bankruptcy under the Bankruptcy Law had not been made and is therefore able to enforce its security before and after the commencement of bankruptcy proceedings[32].

*Transactions in fraud of creditors*

9.21 Under the Fraudulent Dispositions Law (1996 Revision) every disposition of property made with an intent to defraud (which means an intention willfully to defeat an obligation owed to another creditor) and at an undervalue shall be voidable at the instance of the creditor thereby prejudiced. We believe this provision would only apply in the context of the Covered Base Agreement and CDA if the relevant debtor has the requisite intention at the time of entering into the relevant Covered Base Agreement and CDA[33]. Similarly in relation to the on-going provision of security whether under the mark-to-market provisions or otherwise, we believe the points raised above in relation to Section 145(1) of the Companies Law would be

[32] See the answer to question 17.

[33] There is however an English case (*MC Bacon* (1990) BCLC 324) that suggests that a grant of security cannot be at an undervalue (although substantial doubt was cast on this conclusion in obiter comments made by Arden LJ in *Hill v Spread Trustee Company Ltd and another* [2006] All ER (D) 202 (May)). These cases would be persuasive but not binding on the Cayman Islands' courts

relevant. An action under this law is required to be brought within 6 years of the date of disposition. The Fraudulent Dispositions Law (1996 Revision) applies whether or not the Customer becomes insolvent and it applies to Companies, Partnerships and Trustees.

10 **Collateral Security Interest - Assumptions**

We assume the same facts and assumptions as set forth above (as applicable) with the following modification:

The security interest granted by the Customer to the FCM is over the Trust Assets themselves (i.e. a security interest is created directly over the assets that constitute the Collateral) rather than the Trust Beneficial Interest (the "**Collateral Security Interest**).

*How would your response to the questions above change, if at all, assuming that the security interest created by the Customer is a Collateral Security Interest as opposed to a Trust Security Interest? In responding to this question please consider the different Fact Patterns set out above.*

10.1 Our responses in relation to the validity, perfection and priority of the security interest granted by the Customer wouldn't change if the Customer created security over the Trust Assets instead of the Trust Beneficial Interest.

*Would the courts of the Cayman Islands recognise the Collateral Security Interest in each type of Collateral created under each Covered Base Agreement and CDA? In answering this question, please bear in mind the different forms in which securities Collateral may be held, as described in assumption 6.2 above. Please indicate, in relation to cash Collateral, if your answer depends on the location of the account in which the relevant obligations are recorded and/or upon the currency of those obligations*.

10.2 Yes, assuming the same is true as a matter of the Governing Law. There is nothing in the nature of the assets referred to earlier in the description of the Collateral that would prevent the recognition of a security interest in them as a matter of Cayman Islands law assuming that the security interest was valid under the Governing Law of the relevant Covered Base Agreement and CDA and that all appropriate steps had been taken in accordance with the rules outlined in paragraphs 7.8 – 7.14.

10.3 In accordance with Section 142(1) of the Companies Law and Section 36(4) of the Exempted Limited Partnership Law, notwithstanding that a winding up order has been made, a creditor who has security over the whole or part of the assets of a Company or an Exempted Limited Partnership is entitled to enforce his security without the leave of the Court and without reference to the liquidator, irrespective of the identity of the assets subject to such security interest.

Our answers are not dependent on the location of the cash Collateral or the currency of those obligations, unless such cash is located in the Cayman Islands in which case different perfection and priority rules may apply to such security interests.

*What is the effect, if any, under the laws of the Cayman Islands, of the fact that the amount secured or the amount of Collateral subject to the security interest will fluctuate under the Covered Base Agreement and CDA (including as a result of entering into additional Covered Transactions from time to time)? In particular:*

*(a) would the security interest be valid in relation to future obligations of the Customer?*

*(b) would the security interest be valid in relation to future Collateral (that is, Collateral not yet delivered to the relevant party at the time of entry into the relevant Covered Base Agreement and CDA)?*

*(c) is there any difficulty with the concept of creating a security interest over a fluctuating pool of assets, for example, by reason of the impossibility of identifying in the Covered Base Agreement and CDA the specific assets transferred by way of security?*

*(d) is it necessary under the laws of the Cayman Islands for the amount secured by each Covered Base Agreement and CDA to be a fixed amount or subject to a fixed maximum amount?*

*(e) is it permissible under the laws of the Cayman Islands for the FCM to hold Collateral in excess of its actual exposure to the Customer under the related Covered Base Agreement and CDA?*

10.4 There is no difficulty under Cayman Islands law with the fact that the amount secured by the relevant Covered Base Agreement and CDA or the amount of Collateral subject to the security interest under the relevant Covered Base Agreement and CDA will fluctuate (assuming the same to be true as a matter of the Governing Law). In particular:

10.4.1 The security interest would apply to future obligations of the Customer which the terms of the relevant Covered Base Agreement and CDA provide are to be secured by the security interest created by the relevant Covered Base Agreement and CDA (assuming the same to be true as a matter of the Governing Law).

10.4.2 The security interest would be valid in relation to Collateral which, under the terms of the relevant Covered Base Agreement and CDA, becomes subject to the security interest created by the relevant Covered Base Agreement and CDA (assuming the same to be true as a matter of the Governing Law).

10.4.3 There is no difficulty with the concept of creating a security interest over a fluctuating pool of assets (assuming the same to be true as a matter of the Governing Law).

10.4.4 It is not necessary under Cayman Islands law for the amount secured by the relevant Covered Base Agreement and CDA to be a fixed amount or subject to a fixed maximum amount. It should be noted that if the original Covered Base Agreement and CDA (or a duplicate original) is executed in or comes into the Cayman Islands after execution outside the Cayman Islands, stamp duty of CI$2 will be payable. Where any of the property is situated in the Cayman Islands, the amount payable will be 1.5% of the sum secured. Where the Security Collateral Provider is an exempted company, an ordinary non-resident company, an exempted trust or a foreign company or where the property situated in the Cayman Islands is shares in an exempted company or an ordinary non-resident company, the amount payable will be subject to a maximum amount of duty of CI$500.00 (US$609). Where the amount secured is unlimited, the security will only be available, as a matter of Cayman Islands law, for the amount the duty paid covers. Where the amount secured exceeds the level of duty paid it is possible to pay the additional stamp duty to ensure that the security remains effective, as a matter of Cayman Island law, for the full amount secured. If the Security Collateral Provider is an entity to which the CI$500 maximum amount of duty applies and there is no fixed amount secured, we are of the view that the CI$500 maximum amount of duty would be payable.

10.4.5 There is no difficulty under Cayman Islands law in the FCM holding Collateral in excess of its exposure to the Customer provided the same is true under the Governing Law.

10.5 In relation to future Collateral in the form of contractual rights, additional steps may be required in order to ensure the validity, perfection and priority of any security interest over such future Collateral. Please see paragraph 7.13.5 below.

*Assuming that (a) pursuant to the laws of the Cayman Islands, the laws of another jurisdiction govern the creation and/or perfection of the Collateral Security Interest (for example, because such Collateral is located or deemed to be located outside the Cayman Islands) and (b) the FCM has obtained a valid and perfected Collateral Security Interest under the laws of such other jurisdiction, will the FCM have a valid Collateral Security Interest so far as the laws of the Cayman Islands are concerned? Is any action (filing, registration, notification, stamping or notarising or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) under the laws of the Cayman Islands required to establish, perfect, continue or enforce the Collateral Security Interest? Are there any other requirements of the type referred to in the question above (in relation to a Collateral Security Interest rather than a Trust Security Interest)*?

10.6 The FCM will have a valid security interest in the Collateral in these circumstances. No other actions are necessary or required under the laws of the Cayman Islands to establish, perfect, continue or, subject to the payment of any applicable Cayman Islands stamp duty, to enforce the security interest.

10.7 As noted above in paragraph 10.6, Section 142(1) of the Companies Law and Section 36(4) of the Exempted Limited Partnership Law provides that a creditor who has security over the whole or part of the assets of a Company or Exempted Limited Partnership is entitled to enforce his security without the leave of the Court and without reference to the liquidator notwithstanding that a winding up order has been made against such Company or Exempted Limited Partnership (subject to the discussion in paragraph 7.21).

*Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the creation and/or perfection of the Collateral Security Interest (for example, because such Collateral is located or deemed located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected Collateral Security Interest under the laws of such other jurisdiction, are there any formalities, notification requirements or other procedures, if any, that the FCM must observe or undertake in your jurisdiction in exercising its Enforcement Liquidation Rights (including the operation of the Determination of Account)?*

10.8 No. We refer you to the discussion in sections 10.6-10.7 above.

## 11 Additional Considerations

*Are there any other local law considerations that you would recommend the FCM to consider in connection with exercising the Enforcement Liquidation Rights (including the operation of the Determination of Account)?*

10.2 No.

*Are there any other circumstances you can foresee that might affect the FCM's ability to exercise the Enforcement Liquidation Rights (including the operation of the Determination of Account) in the Cayman Islands?*

10.3 No.

This Memorandum has been prepared for the International Swaps and Derivatives Association, Inc. ("**ISDA**") and the Futures Industry Association (the "**FIA**") and each of their members and may not be relied upon by any other person. Without limiting the foregoing, ISDA, the FIA and their members may provide a copy of this Memorandum to (i) any competent regulatory authority or supervisory body (including the UK Financial Services Authority and the German Bundesanstalt für Finanzdienstleistungsaufsicht), and (ii) their legal advisors, solely in that capacity, provided that this Memorandum may not be relied upon by such parties.

Maples and Calder

## APPENDIX A

### Covered Transactions

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Forward. A transaction in which one party agrees to pay an agreed price for a specified amount of a bond of an issuer or a basket of bonds of several issuers at a future date and the other party agrees to pay a price for the same amount of the same bond to be set on a specified date in the future. The payment calculation is based on the amount of the bond and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the COMEX Division of the New York Mercantile Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a “spot” or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, “Bullion” means gold, silver, platinum or palladium and “Ounce” means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce (or in the case of reference prices not expressed in Ounces, the relevant Units of gold, silver, platinum or palladium).

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security (or in some cases an equivalent security) to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate, floating index or floating commodity price payer on the cap and the other party is the floating rate, floating index or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price, and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. A Commodity Forward may be settled by the physical delivery of the commodity in exchange for the specified price or may be cash settled based on the difference between the agreed forward price and the prevailing market price at the time of settlement. Commodity Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index based on the price of one or more commodities.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (e.g., West Texas Intermediate Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Contingent Credit Default Swap. A Credit Default Swap Transaction under which the calculation amounts applicable to one or both parties may vary over time by reference to the mark-to-market value of a hypothetical swap transaction.

Credit Default Swap Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to enter into a Credit Default Swap.

Credit Default Swap. A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. A Credit Default Swap may also be physically settled by payment of a specified fixed amount by one party against delivery of specified obligations (“Deliverable Obligations”) by the other party. A Credit Default Swap may also refer to a “basket” (typically ten or less) or a “portfolio” (eleven or more) of Reference Entities or may be an index transaction consisting of a series of component Credit Default Swaps.

Credit Derivative Transaction on Asset-Backed Securities. A Credit Default Swap for which the Reference Obligation is a cash or synthetic asset-backed security. Such a transaction may, but need not necessarily, include “pay as you go” settlements, meaning that the credit protection seller makes payments relating to interest shortfalls, principal shortfalls and write-downs arising on the Reference Obligation and the credit protection buyer makes additional fixed payments of reimbursements of such shortfalls or write-downs.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Economic Statistic Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency by reference to interest rates or other factors and the other party pays or may pay an amount or periodic amounts of a currency based on a specified rate or index pertaining to statistical data on economic conditions, which may include economic growth, retail sales, inflation, consumer prices, consumer sentiment, unemployment and housing.

Emissions Allowance Transaction. A transaction in which one party agrees to buy from or sell to the other party a specified quantity of emissions allowances or reductions at a specified price for settlement either on a "spot" basis or on a specified future date. An Emissions Allowance Transaction may also constitute a swap of emissions allowances or reductions or an option whereby one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which the specified quantity of emissions allowances or reductions exceeds or is less than a specified strike. An Emissions Allowance Transaction may be physically settled by delivery of emissions allowances or reductions in exchange for a specified price, differing vintage years or differing emissions products or may be cash settled based on the difference between the market price of emissions allowances or reductions on the settlement date and the specified price.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity and shares to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of shares of an issuer or a basket of shares of several issuers at a specified strike price. The share option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed or floating rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor’s 500 Index.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A deliverable or non-deliverable transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Freight Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency based on a fixed price and the other party pays an amount or periodic amounts of the same currency based on the price of chartering a ship to transport wet or dry freight from one port to another; all calculations are based either on a notional quantity of freight or, in the case of time charter transactions, on a notional number of days.

Fund Option Transaction: A transaction in which one party grants to the other party (for an agreed payment or other consideration) the right, but not the obligation, to receive a payment based on the redemption value of a specified amount of an interest issued to or held by an investor in a fund, pooled investment vehicle or any other interest identified as such in the relevant Confirmation (a “Fund Interest”), whether i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests in relation to a specified strike price. The Fund Option Transactions will generally be cash settled (where settlement occurs based on the excess of such redemption value over such specified strike price (in the case of a call) or the excess of such specified strike price over such redemption value (in the case of a put) as measured on the valuation date or dates relating to the exercise date).

Fund Forward Transaction: A transaction in which one party agrees to pay an agreed price for the redemption value of a specified amount of i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests at a future date and the other party agrees to pay a price for the redemption value of the same amount of the same Fund Interests to be set on a specified date in the future. The payment calculation is based on the amount of the redemption value relating to such Fund Interest and generally cash-settled (where settlement occurs based on the difference between the agreed forward price and the redemption value measured as of the applicable valuation date or dates).

Fund Swap Transaction: A transaction a transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency based on the redemption value of i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Longevity/Mortality Transaction. (a) A transaction employing a derivative instrument, such as a forward, a swap or an option, that is valued according to expected variation in a reference index of observed demographic trends, as exhibited by a specified population, relating to aging, morbidity, and

mortality/longevity, or (b) A transaction that references the payment profile underlying a specific portfolio of longevity- or mortality- contingent obligations, e.g. a pool of pension liabilities or life insurance policies (either the actual claims payments or a synthetic basket referencing the profile of claims payments).

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as oil including oil products, coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Property Index Derivative Transaction. A transaction, often structured in the form of a forward, option or total return swap, between two parties in which the underlying value of the transaction is based on a rate or index based on residential or commercial property prices for a specified local, regional or national area.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities (or in some cases equivalent securities) from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

Swap Deliverable Contingent Credit Default Swap. A Contingent Credit Default Swap under which one of the Deliverable Obligations is a claim against the Reference Entity under an ISDA Master Agreement with respect to which an Early Termination Date (as defined therein) has occurred.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.

**APPENDIX B**

**September 2009**

**Counterparty[34]**

| **Description** | **Covered by opinion** | **Legal form(s)** |
|---|---|---|
| Bank/Credit Institution. A legal entity, which may be organized as a corporation, partnership or in some other form, that conducts commercial banking activities, that is, whose core business typically involves (a) taking deposits from private individuals and/or corporate entities and<br>(b) making loans to private individual and/or corporate borrowers. This type of entity is sometimes referred to as a "commercial bank" or, if its business also includes investment banking and trading activities, a "universal bank". (If the entity only conducts investment banking and trading activities, then it falls within the "Investment Firm/Broker Dealer" category below.) This type of entity is referred to as a "credit institution" in European Community (**EC**) legislation. This category may include specialised types of bank, such as a mortgage savings bank (provided that the relevant entity accepts deposits and makes loans), or such an entity may be considered in the local jurisdiction to constitute a separate category of legal entity (as in the case of a building society in the United Kingdom (**UK**)). | Yes | Entities as set out in section 1.1 of this opinion |
| Central Bank. A legal entity that performs the function of a central bank for a Sovereign or for an area of monetary union (as in the case of the European Central Bank in respect of the euro zone). | Yes | Entities as set out in section 1.1 of this opinion |

[34] In these definitions, the term "legal entity" means an entity with legal personality other than a private individual.

| Description | Covered by opinion | Legal form(s) |
|---|---|---|
| Corporation. A legal entity that is organized as a corporation or company rather than a partnership, is engaged in industrial and/or commercial activities and does not fall within one of the other categories in this Appendix B. | Yes | A company, including any exempted, ordinary resident, ordinary non-resident, segregated portfolio company and limited duration company incorporated under the Companies Law (2018 Revision) and a limited liability company formed under the Limited Liability Companies Law (2018 Revision). |
| Hedge Fund/Proprietary Trader. A legal entity, which may be organized as a corporation, partnership or in some other legal form, the principal business of which is to deal in and/or manage securities and/or other financial instruments and/or otherwise to carry on an investment business predominantly or exclusively as principal for its own account. | Yes | Entities as set out in section 1.1 of this opinion |
| Insurance Company. A legal entity, which may be organised as a corporation, partnership or in some other legal form (for example, a friendly society or industrial & provident society in the UK), that is licensed to carry on insurance business, and is typically subject to a special regulatory regime and a special insolvency regime in order to protect the interests of policyholders. | Yes | Entities as set out in section 1.1 of this opinion |
| International Organization. An organization of Sovereigns established by treaty entered into between the Sovereigns, including the International Bank for Reconstruction and Development (the World Bank), regional development banks and similar organizations established by treaty. | No | N/A |
| Investment Firm/Broker Dealer. A legal entity, which may be organized as a corporation, partnership or in some other form, that does not conduct commercial banking activities but deals in and/or manages securities and/or other financial instruments as an agent for third parties. It may also conduct such activities as principal (but if it | Yes | Entities as set out in section 1.1 of this opinion |

| Description | Covered by opinion | Legal form(s) |
|---|---|---|
| does so exclusively as principal, then it most likely falls within the "Hedge Fund/Proprietary Trader" category above.) Its business normally includes holding securities and/or other financial instruments for third parties and operating related cash accounts. This type of entity is referred to as a "broker-dealer" in US legislation and as an "investment firm" in EC legislation. | | |
| Investment Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide investors with a share in profits or income arising from property acquired, held, managed or disposed of by the manager(s) of the legal entity or arrangement or a right to payment determined by reference to such profits or income. This type of entity or arrangement is referred to as a "collective investment scheme" in EC legislation. It may be regulated or unregulated. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by general law and/or, typically in the case of regulated Investment Funds, financial services legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Investment Fund (for example, a trustee of a unit trust) contract on behalf of the Investment Fund, are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement. | Yes | Entities as set out in section 1.1 of this opinion |
| Local Authority. A legal entity established to administer the functions of local government in a particular region within a Sovereign or State of a Federal Sovereign, for example, a city, county, borough or similar area. | No | N/A |
| Partnership. A legal entity or form of arrangement without legal personality that is (a) organised as a general, limited or some other form of partnership and (b) does not fall within one of the other categories in this Appendix B. If it does not have legal personality, it may nonetheless be treated as though it were a legal person for certain purposes (for example, for insolvency purposes) | Yes | An exempted limited partnership established under the Exempted Limited Partnership Law (2018 Revision) or a limited partnership established under the Partnership Law (2013 Revision), each with one or more. |

| Description | Covered by opinion | Legal form(s) |
|---|---|---|
| and not for other purposes (for example, tax or personal liability). | | general partners. |
| Pension Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide pension benefits to a specific class of beneficiaries, normally sponsored by an employer or group of employers. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by pensions legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Pension Fund (for example, a trustee of a pension scheme in the form of a common law trust) contract on behalf of the Pension Fund and are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement. | Yes | Entities as set out in section 1.1 of this opinion |
| Sovereign. A sovereign nation state recognized internationally as such, typically acting through a direct agency or instrumentality of the central government without separate legal personality, for example, the ministry of finance, treasury or national debt office. This category does not include a State of a Federal Sovereign or other political sub-division of a sovereign nation state if the sub-division has separate legal personality (for example, a Local Authority) and it does not include any legal entity owned by a sovereign nation state (see "Sovereign-owned Entity"). | No | N/A |

| Description | Covered by opinion | Legal form(s) |
|---|---|---|
| Sovereign Wealth Fund. A legal entity, often created by a special statute and normally wholly owned by a Sovereign, established to manage assets of or on behalf of the Sovereign, which may or may not hold those assets in its own name. Such an entity is often referred to as an "investment authority". For certain Sovereigns, this function is performed by the Central Bank, however for purposes of this Appendix B the term "Sovereign Wealth Fund" excludes a Central Bank. | No | N/A |
| Sovereign-Owned Entity. A legal entity wholly or majority-owned by a Sovereign, other than a Central Bank, or by a State of a Federal Sovereign, which may or may not benefit from any immunity enjoyed by the Sovereign or State of a Federal Sovereign from legal proceedings or execution against its assets. This category may include entities active entirely in the private sector without any specific public duties or public sector mission as well as statutory bodies with public duties (for example, a statutory body charged with regulatory responsibility over a sector of the domestic economy). This category does not include local governmental authorities (see "Local Authority"). | No | N/A |
| State of a Federal Sovereign. The principal political sub- division of a federal Sovereign, such as Australia (for example, Queensland), Canada (for example, Ontario), Germany (for example, Nordrhein-Westfalen) or the United States of America (for example, Pennsylvania). This category does not include a Local Authority. | No | N/A |

# Appendix C

## Linklaters Summary

12 February 2020

# MEMORANDUM OF LAW
# FOR THE FUTURES INDUSTRY ASSOCIATION
# AND THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

in respect of (i) the recognition under English law of (a) New York law as the governing law of the Clearing Agreement and the Agent-Trust arising under the Clearing Agreement and (b) U.S. Federal law as the governing law of the Statutory Trust arising under the Clearing Agreement and (ii) the mandatory principles of English law that may affect the positions reached under New York law or U.S. Federal law in respect of the operation of the Clearing Agreement, the Agent-Trust and the Statutory Trust.

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Ref L-277835

# I. Introduction

## 1 Overview

**1.1** We have acted as English legal advisers to the Futures Industry Association ("**FIA**") and the International Swaps and Derivatives Association, Inc. ("**ISDA**") in connection with this Memorandum.

**1.2** In this Memorandum, we address (i) the recognition under English law of (a) New York law as the governing law of the Clearing Agreement and the Agent-Trust[1] arising under the Clearing Agreement and (b) U.S. Federal law as the governing law of the Statutory Trust arising under the Clearing Agreement and (ii) the mandatory principles of English law that may affect the positions reached under New York law or U.S. Federal law in respect of the operation of the Clearing Agreement, the Agent-Trust and the Statutory Trust.

**1.3** The analysis that follows is split into four parts. Section I sets out the scope of this Memorandum and the assumptions to which it is subject; Section II sets out our analysis of the U.S. FCM clearing model under English law by reference to the S&C Memorandum and the summary of the U.S. FCM clearing model provided by the FIA and ISDA set out in Annex 1 of this Memorandum (the "**Summary Annex**"); Section III sets out the questions that we have been asked to address in the instruction letter sent by FIA and ISDA (the "**Instructions**", as set out in Annex 2 of this Memorandum), followed by our responses (which are based on the analysis and conclusions in Section II) and Section IV sets out the qualifications to which this Memorandum is subject.

## 2 English law

This Memorandum is limited to, and shall only be construed in accordance with, English law, including the laws of the European Union that are directly applicable in England without further implementing legislation, as applied by the English courts and in effect on the date of this Memorandum. Accordingly, this Memorandum does not address the laws of any jurisdiction other than England, and does not take into account any impact that the laws (including any insolvency or bankruptcy laws) of any jurisdiction other than England may have on the statements made in this Memorandum even if, as a result of the application of English law provisions on the conflict of laws, the laws of any such other jurisdiction may apply.

In this Memorandum, a reference to "English law" is a reference to the law of England and Wales and, unless the context indicates otherwise, a reference to "England" is a reference to the legal jurisdiction of England and Wales.

We do not undertake to update this Memorandum, including in the event of a change in law or practice.

[1] References throughout this document to the "Agent-Trust" are to the capacity in which an FCM holds the Customer Transactions for the benefit of the Customer as a result of its agency relationship with the Customer, as described in the S&C Memorandum and as summarised in the Summary Annex.

## 3 Interpretation

**3.1** In this Memorandum:

(a) "**Agent-Trust**" has the meaning given to the term "agent-trust" in the Summary Annex;

(b) "**Agent-Trust Beneficial Interest**" means a Customer's beneficial interest in the Agent-Trust Property;

(c) "**Agent-Trust Property**" means the Customer Transactions held by the FCM on the terms of the agent-trust;

(d) "**Bank Holding Company**" means a company registered in England under the Companies Act that is the parent undertaking of a Bank, a Building Society or an Investment Firm. For the purposes of this definition, "**Bank**" has the meaning given to it in section 2 of the Banking Act; "**Building Society**" has the meaning given to it in section 119 of the Building Societies Act 1986; and "**Investment Firm**" has the meaning given to it in section 258A of the Banking Act;

(e) "**Banking Act**" means the Banking Act 2009 (as amended);

(f) "**Banking Group Company**" has the meaning given to it in section 81D of the Banking Act;

(g) "**Chargeable Costs**" has the meaning given to it in paragraph 3.6 of Section II of this Memorandum;

(h) "**Charity**" means a charity registered in England within the meaning of section 1 of the Charities Act 2011 (as amended) and established as a company under the Companies Act;

(i) "**Cleared Derivatives Liquidation**" has the meaning given to it in the Summary Annex;

(j) "**Cleared Derivatives Transactions**" has the meaning given to it in the Cleared Derivatives Addendum;

(k) "**Clearing Agreement**" means the documentation entered into between a Customer and the FCM being any of:

(i) in relation to a Customer entering into futures transactions cleared by a DCO, a futures customer account agreement governed by the law of the State of New York (a "**Futures and Options Agreement**");

(ii) in relation to a Customer entering into Cleared Derivatives Transactions only, a Futures and Options Agreement and a cleared derivatives addendum to it (which is annexed to, and forms a part of, such Futures and Options Agreement) each governed by the law of the State of New York (a "**Cleared Derivatives Addendum**");

(iii) in relation to a Customer entering into Cleared Derivatives Transactions

and futures transactions, a Futures and Options Agreement and the Cleared Derivatives Addendum to it each governed by the law of the State of New York,

in each case including any DCO rules that it is subject to;

(l) "**Companies Act**" means the Companies Act 2006 (as amended) and its predecessors;

(m) "**Contractual Foreign Law Exceptions**" has the meaning given to it in paragraph 2.1 of Section II of this Memorandum;

(n) "**Convention**" has the meaning given to it in paragraph 3.1.1(a) of Section II of this Memorandum;

(o) "**Customer**" means a customer of the FCM which has entered into a Clearing Agreement with the FCM and is an entity type that is within the scope of this Memorandum, as set out in paragraph 4 of this Section I;

(p) "**Customer Account**" has the meaning given to the term "customer account" in the Summary Annex;

(q) "**Customer Funds**" has the meaning given to the term "customer funds" in the Summary Annex;

(r) "**Customer Transaction**" means a futures transaction and/or Cleared Derivatives Transaction cleared by a DCO, entered into pursuant to a Clearing Agreement;

(s) "**DCO**" means one or more derivatives clearing organisations registered with the U.S. Commodity Futures Trading Commission (the "**CFTC**") pursuant to the U.S. Commodity Exchange Act (the "**CEA**"), each of which acts as a central counterparty for exchange-traded futures and options on futures transactions and/or swaps transactions (as defined in the CEA and the CFTC regulations thereunder), which may initially be effected on an exchange, by means of another execution facility or over the counter;

(t) "**Determination of Account**" means the determination by the FCM of an aggregate net amount payable in connection with the liquidation or deemed liquidation (if applicable) of the Customer Transactions as described in paragraphs 2.7 and 2.11 – 2.14 of the Summary Annex;

(u) "**English Company**" has the meaning given to it in paragraph 4 of this Section I;

(v) "**Excluded Company**" means a company that is (i) established under statute (other than the Companies Act), (ii) established by royal charter granted by the Crown, (iii) an Insurer, (iv) a Charity, (v) a Banking Group Company or a Bank Holding Company, (vi) a water and sewage undertaker under the Water Industry Act 1991, (vii) a qualifying water supply licensee within the meaning of section 23(6) of the Water Industry Act 1991 or a qualifying sewerage licensee within the

meaning of section 23(8) of the Water Industry Act 1991, (viii) a licensed infrastructure provider within the meaning of the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013, (ix) a protected railway company under the Railways Act 1993 (as extended by the Channel Tunnel Rail Link Act 1996), (x) an air traffic services company under the Transport Act 2000, (xi) a public-private partnership company under the Greater London Authority Act 1999 or (xii) an underwriting member of Lloyd's of London;

(w) "**FC Regulations**" means the Financial Collateral Arrangements (No. 2) Regulations 2003 (as amended);

(x) "**FCM**" means a U.S. registered futures commission merchant;

(y) "**FSMA**" means the Financial Services and Markets Act 2000 (as amended);

(z) "**Futures Liquidation**" has the meaning given to it in the Summary Annex;

(aa) "**General Insolvency Principles**" has the meaning given to it in paragraph 4.1(iii) of Section II of this Memorandum;

(bb) "**Insolvency Act**" means the Insolvency Act 1986 (as amended);

(cc) "**Insolvency Rules**" means the Insolvency (England and Wales) Rules 2016 (as amended);

(dd) "**Instructions**" has the meaning given to it in paragraph 1.3 of this Section I and is set out in Annex 2 of this Memorandum;

(ee) "**Insurer**" means a company registered in England under the Companies Act which has permission under Part 4A of FSMA to carry on the regulated activity of effecting and carrying out contracts of insurance as principal;

(ff) "**Investment Bank Regulations**" means the Investment Bank Special Administration Regulations 2011;

(gg) "**Liquidation**" means either or both of a Cleared Derivatives Liquidation and a Futures Liquidation;

(hh) "**MiFID II**" means Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (as amended);

(ii) "**Net Liquidating Equity**" has the meaning given to the term "net liquidating equity" in the Summary Annex;

(jj) "**Omnibus Customer Positions Account**" has the meaning given to the term "omnibus customer positions account" in the Summary Annex;

(kk) "**Permitted Uses**" has the meaning given to the term "permitted uses" in the Summary Annex;

(ll) "**Proprietary Uses**" has the meaning given to it in paragraph 3.6 of Section II of this Memorandum;

(mm) "**Residual Interest**" has the meaning given to the term "residual interest" in the Summary Annex;

(nn) "**Rome I Regulation**" means Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations [2008] OJ L177/6;

(oo) "**Security Interest**" means the security interest granted by the Customer to the FCM over the Agent-Trust Beneficial Interest and the Statutory Trust Beneficial Interest;

(pp) "**Segregated Account**" has the meaning given to the term "segregated account" in the Summary Annex;

(qq) "**Segregated Funds**" has the meaning given to the term "segregated funds" in the Summary Annex;

(rr) "**Segregated Funds Account**" has the meaning given to the term "segregated funds account" in the Summary Annex.

(ss) "**Segregation Rules**" has the meaning given to the term "segregation rules" in the Summary Annex;

(tt) "**Statutory Avoidance Provisions**" has the meaning given to it in paragraph 4.1 of Section II of this Memorandum;

(uu) "**Statutory Trust**" has the meaning given to the term "statutory trust" in the Summary Annex;

(vv) "**Statutory Trust Beneficial Interest**" means a Customer's beneficial interest in the Statutory Trust Property;

(ww) "**Statutory Trust Property**" means the Segregated Funds held by the FCM on the terms of the statutory trust;

(xx) "**Summary Annex**" has the meaning given to it in paragraph 1.3 of this Section I;

(yy) "**S&C Memorandum**" has the meaning given to it in paragraph 5 of this Section I;

(zz) "**Transaction**" means any transaction entered into pursuant to a Clearing Agreement, including Customer Transactions, Offsetting Transactions, Sale/Novation Transactions, Replacement Transactions, Mitigation Transactions, Risk-reducing Transactions and any transaction entered into in order to effect a Futures Liquidation or a Cleared Derivatives Liquidation (if any)[2];

(aaa) "**Trust Foreign Law Exceptions**" has the meaning given to it in paragraph 3.4 of Section II of this Memorandum;

[2] Further details in respect of the operation of the liquidation mechanics under the Clearing Agreement are set out in the Summary Annex.

(bbb) "**UCC**" means the Uniform Commercial Code in effect in the State of New York; and

(ccc) "**U.S. Clearing Model**" has the meaning given to it in paragraph 5 of this Section I.

**3.2** In this Memorandum, references to the commencement of insolvency proceedings refer to: in the case of a voluntary winding-up, the passing of the members' resolution; in the case of a compulsory winding-up, the making of an order for its winding-up; in the case of an administration (other than a special administration (bank insolvency) and a special administration (bank administration) referred to below), the making of an order for its administration or the filing of the relevant notice with the Court, as the case may be; in the case of a bank insolvency, the date as of which a bank insolvency order is treated as having taken effect in accordance with section 98 of the Banking Act; in the case of a bank administration, the making of a bank administration order in respect of such entity; in the case of a special administration, the making of a special administration order in respect of such entity; in the case of a special administration (bank insolvency), the date as of which a special administration (bank insolvency) order is treated as having taken effect in accordance with paragraph 6 of Schedule 1 of the Investment Bank Regulations; and in the case of a special administration (bank administration), the making of a special administration (bank administration) order in respect of such entity.

**3.3** In this Memorandum, references to an "Agent-Trust" or a "Statutory Trust" (and any associated provisions or concepts) refer to such concepts as set out and explained in the Summary Annex and other capitalised terms used but not defined in this Memorandum have the meanings given to them in the Summary Annex.

## 4 Scope of Customer types covered by this Memorandum

In this Memorandum we consider the issues that you have asked us to address only in respect of a Corporation, if registered as a company in England under the Companies Act, excluding Excluded Companies (an "**English Company**"), and including, without limitation:

(i) a Bank/Credit Institution, if established as an English Company, having its head office in England and permitted under Part 4A of FSMA to carry on the regulated activity of accepting deposits or to issue electronic money, as the case may be, other than an English Company which also has permission under Part 4A of FSMA to effect or carry out contracts of insurance; and

(ii) an Investment Firm/Broker Dealer, if established as an English Company and which is an "investment firm" within the meaning of Article 4(1)(1) of MiFID II that provides services involving the holding of funds or securities for third parties.

We do not consider any other type of entity.

## 5 Scope of material reviewed

For the purposes of this Memorandum, we have read the memorandum prepared by Sullivan & Cromwell LLP entitled "Analysis of the Relationships Among Customers, FCMs and DCOs Under the U.S. Agency Clearing Model" dated 21 November 2018 (the "**S&C Memorandum**") and the supplementary summary of the U.S. clearing model set out in the Summary Annex (the "**U.S. Clearing Model**") and assume the following:

(i) the characterisation and legal effect of the relationships between an FCM, a Customer and a DCO (including the rights and obligations of such parties under the Clearing Agreement) under U.S. Federal law and the law of the State of New York, as applicable, are as set out in the Summary Annex;

(ii) the liquidation process (including the methods by which an FCM may affect a liquidation) following a Customer default under the terms of the Clearing Agreement and its legal effect under the law of the State of New York are as set out in the Summary Annex; and

(iii) the security interest granted by the Customer to the FCM is in the form and over the types of assets set out in the Summary Annex.

We have not repeated the provisions of the Summary Annex in this Memorandum and the Summary Annex should be read in conjunction with this Memorandum.

For the avoidance of doubt, for the purposes of this Memorandum, we have only relied on explanations of the terms of certain underlying documents, as well as the summary of the U.S. Clearing Model set out in the Summary Annex, the S&C Memorandum and the Instructions and we have not reviewed any other documents. We rely on the contents of the Summary Annex, the S&C Memorandum and the Instructions without any further checks for the purposes of providing this Memorandum.

Our analysis is limited to the issues specifically addressed in this Memorandum.

## 6 Assumptions

Our analysis is subject to the assumptions contained within your Instructions (set out in Annex 2), the scope described in paragraph 5 of this Section I and the following additional assumptions:

**6.1** The Clearing Agreement, applicable DCO rules and the Transactions entered into thereunder constitute legal, valid, binding and enforceable obligations as regards the relevant DCO, FCM and the Customer who are party to them under New York law.

**6.2** The applicable DCO rules permit the FCM to effect a Futures Liquidation and a Cleared Derivatives Liquidation and to enter into Offsetting Transactions, Sale/Novation Transactions, Replacement Transactions, Mitigation Transactions or Risk-reducing Transactions following a Customer default, as set out in the Summary Annex.

**6.3** Each of the FCM and the Customer has obtained all licences, approvals, authorisations and consents under all applicable laws which may be necessary in connection with the

Clearing Agreement and any Transaction or arrangement entered into thereunder and is in compliance with all applicable laws in connection with the Clearing Agreement and any Transaction or arrangement entered into thereunder.

**6.4** The Clearing Agreement and any Transactions or arrangements entered into thereunder (including the transfer of Customer Funds by the Customer to the FCM) were entered into prior to the commencement of any insolvency proceedings in relation to the relevant DCO, FCM or Customer and prior to any such party having notice that any insolvency-related events had occurred in relation to the other, except in relation to the Customer at the time of the DCO and the FCM entering into an Offsetting Transaction, Sale/Novation Transaction, Replacement Transaction, Mitigation Transaction, Risk-reducing Transaction and/or any transaction entered into in order to effect a Futures Liquidation or a Cleared Derivatives Liquidation (if any) where the relevant analysis assumes that such transactions are entered into after the commencement of insolvency proceedings with respect to the Customer.

**6.5** The Clearing Agreement and all Transactions and arrangements thereunder have been or will be entered into for *bona fide* commercial reasons, on arm's length commercial terms by the parties and the Clearing Agreement correctly reflects the terms agreed between the parties. In addition, we assume that the Clearing Agreement does not require grossly exorbitant payments and that it does not otherwise grossly contravene ordinary principles of fair dealing.

**6.6** There are no dealings between the parties that affect the operation or interpretation of any provision of the U.S. Clearing Model, the Clearing Agreement, the applicable DCO rules, any Transaction or arrangement entered into thereunder or any assumptions in this Memorandum. No agreement or Transaction entered into between the relevant DCO, the FCM and/or the Customer, or any other party, amends, varies, waives or otherwise affects in any respect the U.S. Clearing Model, the validity of the Clearing Agreement or the ability of (or requirement for) either party to comply with its obligations under it in such a way that would affect the conclusions reached in this Memorandum.

**6.7** All applicable provisions of the FSMA and any applicable secondary legislation made under it have been or will be complied with in respect of anything done by the FCM, the Customer and/or the relevant DCO in relation to the applicable Clearing Agreement and any Transaction or arrangements entered into thereunder.

**6.8** Each Customer Transaction, Offsetting Transaction, Sale/Novation Transaction, Replacement Transaction, Mitigation Transaction, Risk-reducing Transaction and/or any transaction entered into in order to effect a Futures Liquidation or a Cleared Derivatives Liquidation (if any) will be in accordance with the Clearing Agreement and the applicable DCO rules and none of the provisions of any Transactions will affect the conclusions set out in this Memorandum.

**6.9** In respect of the Agent-Trust, Statutory Trust and the Security Interest, no security, trust, right of set-off or other proprietary interest or claims have been granted or exist over or in respect of the assets that form the subject of such trust or security arrangement in favour of anyone other than, in the case of the Security Interest, the FCM .

**6.10** The FCM maintains up-to-date and accurate book-entry records in respect of all Customer Transactions, Customer Accounts and Segregated Funds held by the FCM.

**6.11** The cash and transferable securities comprising the Segregated Funds that are subject to the Security Interest are assets that constitute "financial collateral" for the purposes of the FC Regulations.

**6.12** Any cash held by the FCM (including any cash transferred by the Customer to the FCM or received by the FCM from a DCO) is not subject to the Financial Conduct Authority's client asset and client money rules.

**6.13** Customer Transactions and Segregated Funds do not form part of the FCM's estate on insolvency. We note that there is some discussion in relation to this assumption in the S&C Memorandum and paragraph 1.12 in the Summary Annex. In footnote 28 of this Memorandum, we consider the implications for the analysis and conclusions in this Memorandum if this assumption is not correct.

**6.14** New York law and U.S. Federal law provide that the Agent-Trust Beneficial Interest and Statutory Trust Beneficial Interest is not an interest in any specific asset that constitutes the Agent-Trust Property or the Statutory Trust Property but rather is a beneficial interest in the Agent-Trust Property or Statutory Trust Property (as the case may be) as a whole.[3]

**6.15** In conducting a Liquidation, the FCM will only withdraw amounts from the Segregated Funds for Permitted Uses or Proprietary Uses.

[3] See paragraphs 1.5 and 1.9 of the Summary Annex.

## II. English law analysis of the U.S. Clearing Model

### 1 Introduction

In this Section II we set out our analysis with respect to (i) the recognition under English law of (a) New York law as the governing law of the Clearing Agreement and the Agent-Trust arising under the Clearing Agreement and (b) U.S. Federal law as the governing law of the Statutory Trust arising under the Clearing Agreement and (ii) the mandatory principles of English law that may affect the positions reached under New York or U.S. Federal law in respect of the operation of the Clearing Agreement, the Agent-Trust and the Statutory Trust.

Different conflict of laws principles will apply depending on whether a particular provision of the Clearing Agreement (and, accordingly, the U.S. Clearing Model) is characterised as:

(i) a contractual provision; or

(ii) a term of a trust.

We examine each of the three elements of the U.S. Clearing Model in turn: (i) the contractual provisions relating to aspects of the FCM/Customer relationship (ii) the Agent-Trust and the Statutory Trust and (iii) the Security Interest.

### 2 Contractual provisions of the U.S Clearing Model under English law

#### 2.1 Conflict of laws analysis

So far as English law is concerned, the applicable law of contractual obligations in civil and commercial matters is governed by the Rome I Regulation.[4] Under the Rome I Regulation, subject to certain exceptions (which are discussed below), the governing law is that chosen by the parties. The choice must be express or clearly demonstrated by the terms of the contract or the circumstances of the case.[5] The law chosen does not have to be the law of an EU Member State.[6]

As a result of the Rome I Regulation, therefore, if proceedings were brought before an English court in respect of the Clearing Agreement and New York law is pleaded and proved as a fact in accordance with English procedural and evidential rules, the choice of New York law as the governing law of the Clearing Agreement would be recognised by the English court and, accordingly, New York law would govern the validity, binding effect and enforceability of the Clearing Agreement. This general principle is subject to the following exceptions (the "**Contractual Foreign Law Exceptions**"):

---

[4] The Rome I Regulation applies to contracts entered into on and after 17 December 2009. We do not consider contracts entered into before this date.

[5] Article 3(1) of the Rome I Regulation.

[6] Article 2 of the Rome I Regulation.

(i) effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of a contract have to be or have been performed, insofar as those provisions render the performance of the contract unlawful. In such circumstances, the relevant obligations may not be enforceable;

(ii) where all the other elements relevant to the Clearing Agreement at the time of the choice of governing law are located in a country other than the U.S., it is possible that the choice of New York law will not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement;

(iii) where all other elements relevant to the Clearing Agreement at the time of the choice of the governing law are located in one or more EU Member States and the governing law chosen to apply is not that of an EU Member State, it is possible that the choice of New York law will not prejudice the application by the English courts of provisions of relevant EU law (where appropriate, as implemented in England) which cannot be derogated from by agreement;

(iv) the English courts may have regard to the law of the country in which performance takes place in relation to the manner of performance and the steps to be taken in the event of defective performance;

(v) the English courts may not be restricted from applying overriding mandatory provisions of English law; and

(vi) if there is a provision of New York law that is manifestly incompatible with English public policy, it is possible that the English courts may not apply it.

**2.2** Application of the Contractual Foreign Law Exceptions to the contractual provisions

It therefore falls to be considered whether the contractual provisions of the Clearing Agreement come within the scope of the Contractual Foreign Law Exceptions.

The Contractual Foreign Law Exceptions described in paragraphs 2.1(i), (ii), (iii) and (iv) above are questions of fact. In respect of paragraphs 2.1(i) and (iv), we assume that the performance of the obligations under the Clearing Agreement will occur in the U.S. or in England and that there are no overriding provisions of U.S. Federal or state laws that would make the performance of the contract unlawful. Relevant overriding provisions of English law are discussed further below. We also assume, given the location of the FCM in the U.S. that the Contractual Foreign Law Exceptions referred to in paragraphs 2.1(ii) and (iii) will not apply.

Accordingly, it is the Contractual Foreign Law Exceptions described in paragraph 2.1(v) and (vi) above – that mandatory provisions of English law may override a provision of New York law and that English courts may not apply a provision of New York law that is manifestly incompatible with English public policy – that require English law analysis.

In respect of the Contractual Foreign Law Exception described in paragraph 2.1(v) above, we do not believe that the contractual provisions of the Clearing Agreement

described in the S&C Memorandum and the Summary Annex would be manifestly incompatible with English public policy.

In respect of the Contractual Foreign Law Exception described in paragraph 2.1(vi) above, it is necessary to consider whether application of all or any of the contractual provisions constitute a penalty as a matter of English law.

In *Cavendish Square Holding BV v Talal El Makdessi*[7], the court stated that the test for determining whether or not a provision constitutes a penalty is whether it is "*a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation*". There are therefore two elements to this test. The first is that a provision will only be a penalty if it is a secondary, rather than a primary, obligation. The second is that, even if a provision is a secondary obligation, it will only be a penalty if it bears no relation to the legitimate interests of the innocent party. In the case of a negotiated contract between properly advised parties of comparable bargaining power, there will be a strong initial presumption that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach. In this regard, we do not believe that the contractual provisions of the Clearing Agreement described in the S&C Memorandum and the Summary Annex would constitute a penalty.

Mandatory provisions of English law that apply following commencement of insolvency proceedings are considered in paragraph 4 of this Section II.

Therefore, we consider that, subject to the discussion in paragraph 4 of this Section II, none of the Contractual Foreign Law Exceptions apply and so New York law would be recognised as the governing law of the contractual provisions.

## 3 Trust provisions of the U.S. Clearing Model under English law

### 3.1 Validity of trusts under English law

#### 3.1.1 Approach taken

The constitution of trusts and the relationship between settlors, trustees and beneficiaries are expressly excluded from the scope of the Rome I Regulation. When the English courts are asked to consider the validity of a trust, they must first determine the law chosen to govern its terms.

The English courts determine the governing law:

(a) by applying the Recognition of Trusts Act 1987 (the "**RT Act**") which (with some omissions and extensions) implements the Hague Convention on the Law Applicable to Trusts and on Their Recognition (the "**Convention**") to those trusts which fall within its scope; and

[7] [2015] UKSC 67.

(b) for trusts which are outside the scope of the RT Act, by applying the common law principles governing trust arrangements.

**3.1.2** Trusts within the scope of the RT Act

A trust will be within the scope of the RT Act if it comes within the following definition of a "trust" set out in the Schedule to the RT Act:

> *"The legal relationship created—inter vivos or on death—by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.*
>
> *A trust has the following characteristics—*
>
> *(i) the assets constitute a separate fund and are not a part of the trustee's own estate;*
>
> *(ii) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;*
>
> *(iii) the trustee has the power and the duty, in respect of which it is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon it by law.*
>
> *The reservation by the settlor of certain rights and powers, and the fact that the trustee may itself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.*"[8]

The Convention was originally enacted to apply only to trusts as defined in the Convention if they are created voluntarily and evidenced in writing.[9] Trusts arising by operation of statute are not included in its scope because they do not arise "voluntarily"[10]. S.1(2) of the RT Act in the UK extends the scope of the Convention in the UK to trusts created by statute or under statutory powers, the only requirement being that the trust must arise under the law of some part of the UK.[11] However, as the Statutory Trust does not arise under the laws of any part of the UK, it cannot derive the benefit of this extension.

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[8] Article 2 in the Schedule to the RT Act.

[9] Article 3 in the Schedule to the RT Act.

[10] This point is made in the Explanatory Notes to the Convention at paragraph 49 (which states that "*in particular, the Convention is not applicable to trusts created by operation of law or by judicial decision*"). *Lewin on Trusts* (19th Edition), Paragraph 11-125 (citing in support Piatek v Piatek [2010] QSC 412 at [125] although the comment appears to be obiter and not have been fully argued) and *Dicey, Morris & Collins on the Conflict of Laws* (15th Edition), paragraph 29-006 also suggest that trusts arising by operation of statute are probably not included. The position where the Statutory Trust arises by entering into a contract is not considered in any of these sources.

[11] This provision appears to be ultra vires the Convention, which in Article 20 (that underlies the enactment of s.1(2)) permits the scope of the Convention to be extended to judicial decisions only. We do not think it is necessary to consider this aspect further in this memorandum as the extension clearly does not apply in the context of the Statutory Trust which does not arise under English (or any other UK) law.

Nevertheless, it is arguable that the parties enter into the Clearing Agreement voluntarily and it is as a result of this voluntary arrangement that the Statutory Trust is created. The Statutory Trust could also, therefore, be understood to be entered into voluntarily.[12]

**3.1.3** Governing law of trusts within the scope of the RT Act

If a trust is within the scope of the RT Act, then the rules of the RT Act apply to determine its governing law.

The RT Act codifies a set of rules for identifying the governing law of a trust[13]. The express or implied choice of the settlor takes priority and the settlor's choice is unfettered. If there is no express or implied choice, the governing law is found by applying a series of tests designed to establish the law of the closest connection.

**3.1.4** Governing law of trusts outside the scope of the RT Act

Not all trusts are within the scope of the RT Act. In the case of a trust not covered by the RT Act, the governing law must be established under English procedural and evidential rules. This means that it must be pleaded and proved as a fact in accordance with English procedural and evidential rules that a law has been chosen to be the governing law of a trust arrangement or (in the case of the Statutory Trust) that the parties have voluntarily entered into arrangements that give rise to a trust governed by particular statutory provisions.

**3.1.5** Scope of the chosen governing law where the RT Act applies

Article 8[14] of the Schedule to the RT Act deals with the governing effects of the chosen law. Of relevance here is that the law chosen governs the validity of the trust, its construction, its effects and the administration of the trust. It covers relationships between the trustee and the beneficiaries and the extent of all

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[12] This can be contrasted with a trust arising "purely" as a result of statute, such as trusts created in cases of intestacy.

[13] Articles 6 and 7 in the Schedule to the RT Act.

[14] "*The law specified by Article 6 or 7 shall govern the validity of the trust, its construction, its effects and the administration of the trust. In particular that law shall govern—*

*(a) the appointment, resignation and removal of trustees, the capacity to act as a trustee, and the devolution of the office of trustee;*

*(b) the rights and duties of trustees among themselves;*

*(c) the right of trustees to delegate in whole or in part the discharge of their duties or the exercise of their powers;*

*(d) the power of trustees to administer or to dispose of trust assets, to create security interests in the trust assets, or to acquire new assets;*

*(e) the powers of investment of trustees;*

*(f) restrictions upon the duration of the trust, and upon the power to accumulate the income of the trust;*

*(g) the relationships between the trustees and the beneficiaries including the personal liability of the trustees to the beneficiaries;*

*(h) the variation or termination of the trust;*

*(i) the distribution of the trust assets;*

*(j) the duty of trustees to account for their administration*."

duties owed by the trustee to the beneficiaries, including the duty of care. This is subject to the qualification that the RT Act does not apply to the validity of acts by which assets are transferred to trustees and does not cover the rights and obligations of third parties to the trust with respect to the trust property.

Article 11 of the Schedule to the RT Act contains the provisions for recognition. The general scope of the Article is subject to Article 15 (mandatory rules), Article 16 (overriding rules) and Article 18 (public policy) of the Schedule all of which are described and considered more fully in paragraphs 3.4 and 3.5 of this Section II.

Article 11 provides that a trust created in accordance with the chosen law is to be recognised as a trust and such recognition implies, as a minimum, that trust property constitutes a separate fund, that the trustee may sue and be sued in its capacity as trustee and that the trustee may appear or act in this capacity before a notary or any person acting in an official capacity.

Article 11 goes on to provide that in so far as the law applicable to the trust requires or provides, amongst other things, such recognition shall imply in particular:

(a) that personal creditors of the trustee shall not form part of the trustee's estate upon its insolvency or bankruptcy;

(b) that the trust assets shall not form part of the trustee's estate upon its insolvency or bankruptcy; and

(c) that the trust assets may be recovered when the trustee, in breach of trust, has mingled the trust assets with its own property or has alienated trust assets. However, the rights and obligations of any third party holder of the assets shall remain subject to the law determined by the choice of law rules of the forum.

The RT Act does not replace otherwise applicable law relating to trusts outside the scope of the RT Act or the consequences of recognition beyond those set out in the RT Act.

**3.1.6** Scope of the chosen governing law where the RT Act does not apply

There is limited authority for the scope of the English common law rules relating to the determination of the validity of a trust outside the scope of the RT Act. If it has been pleaded and proved as a fact (in accordance with English procedural and evidential rules) that a law has been chosen to be the governing law of a trust arrangement (or that the parties have voluntarily entered into arrangements that give rise to a trust governed by particular statutory provisions), it is unclear whether the essential characterisation of such an arrangement as a trust must be determined in accordance with the chosen law or English law.

(a) If as a matter of English law the governing law of the arrangement determines whether it should be characterised as a trust, English law will

defer to such governing law, which will govern characterisation and validity of the trust.

(b) If, on the other hand, as a matter of English law it fell to the English courts to consider whether an arrangement governed by the laws of a different jurisdiction constitute a trust (as a result of the governing law of the trust not being determinative of the characterisation), the English courts would look to determine what the essential and defining characteristics of a trust are and then ascertain whether the arrangement in question (governed, in the present case, by either New York law in respect of the agent-trust or U.S. Federal law in respect of the statutory trust) has these characteristics.

*Characterisation of a trust under English law*

We analyse in this section how a trust arrangement whose governing is determined to be foreign law would be characterised under English common law, if it fell to the English courts to the determine such a trust arrangement's characterisation (as a result of the governing law of the trust not being determinative of the characterisation).

There is no single definition of a trust under English law that has been widely adopted as definitive. Several definitions have been proposed, each containing various degrees of description of what constitutes a trust under English law. However, what can be described as the hallmark of a trust under English law, is that a person in whom the property is vested is compelled in equity to hold the property for the benefit of another person or for a charitable, or other legally recognised, purpose. The effect and essence of the trust is to divide the incidents of ownership of the property between the trustee and the beneficiary. The legal ownership vests in the trustee but, when a person holds property as trustee, it is treated in equity as taking it subject to the beneficiary's equitable rights. Under English common law, the existence of this feature is generally sufficient for the relationship to be defined as a trust.[15]

It is clear from both the RT Act and English common law that the law that governs the validity of the trust (in this case, the chosen law) determines the nature of the interest of the beneficiary in the trust and the trust property.

**3.2** Application of the RT Act or the common law to the Agent-Trust and the Statutory Trust

**3.2.1** In the case of the Agent-Trust:

(i) there are good arguments that the Agent-Trust falls within the definition of a "trust" under the RT Act as the Customer Transactions are placed

[15] *Snell's Equity* (33rd Edition), Chapter 21.1.1.

under the control of the FCM[16] for the benefit of a Customer and the Agent-Trust is consistent with each of the three characteristics contained within the definition set out in paragraph 3.1.2 of this Section II[17];

(ii) the fact that there is no declaration of the trust in writing and the Customer retains some control over the Customer Transactions creates some uncertainty as to whether the RT Act would apply to such a trust;

(iii) if the RT Act is applicable, it would provide that New York law would be recognised as the governing law of the Agent-Trust by an English court; and

(iv) as there is some uncertainty that the Agent-Trust would fall within the scope of the RT Act, we also consider its recognition under English common law principles. If the English common law principles provide that English law would look to the law governing an arrangement to determine its characterisation, then such principles would provide that New York law is recognised as the governing law of the Agent-Trust by an English court and would also govern its characterisation. However, we set out in paragraph 3.3.1 of this Section II our analysis if the English common law principles provide that English law would determine the characterisation of the Agent-Trust instead.

**3.2.2** In the case of the Statutory Trust:

(i) subject to footnote 28 of this Memorandum, the Statutory Trust clearly falls within the definition of a "trust" under the RT Act as the assets are similarly placed under the control of the FCM for the benefit of a Customer and the Statutory Trust is consistent with each of the three characteristics contained within the definition set out in paragraph 3.1.2 of this Section II;

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[16] As the legal title-holder of the Customer Transactions, the FCM arguably has control of the Customer Transactions (which it holds for the benefit of the Customers). We note however, that unlike a classic trustee, in its capacity as "agent-trustee", the FCM holds title to the Customer Transactions "subject to the control of its principal" (see footnote 6 of the Summary Annex), which reflects the nature of the agency relationship between the parties. Although this may on the face of it appear to contradict the RT Act requirement, we think the better interpretation of this is that the FCM has control over the Customer Transactions but its rights as legal title-holder are fettered by the Customer's right to direct the FCM in respect of the Customer Transactions pursuant to the provisions of the Clearing Agreement and we note from paragraph 3.1.2 of this Section II that "*[t]he reservation by the settlor of certain rights and powers … are not necessarily inconsistent with the existence of a trust*" (although this view is not free from doubt).

[17] The trustee's fiduciary obligations (owed as trustee, as opposed to fiduciary obligations owed in any other capacity) appears to be a core feature of an in-scope trust for the purposes of Convention (see Paragraph 40 of the Explanatory Note to the Hague Convention). As the RT Act implements the Convention, English courts may decide to apply the same construction while analysing trust arrangements under the RT Act. We understand from the description of the Agent-Trust in the Summary Annex that the fiduciary obligations owed by the FCM to the Customer arises under the agency relationship rather than the trust relationship. This may weaken the argument in favour of the Agent-Trust being a type of RT Act trust, notwithstanding that on the face of it, the three characteristics contained within the definition set out in paragraph 3.1.2 of this Section II appear to be met.

(ii) as noted above, it is not certain that trusts created by statute can be considered to have been created voluntarily (within the meaning of the RT Act) and would therefore fall within the RT Act;

(iii) if the RT Act is applicable, it would provide that U.S. Federal law is recognised as the governing law of the Statutory Trust by an English court; and

(iv) as it is not certain that the Statutory Trust would fall within the scope of the RT Act, we also consider its recognition under English common law principles. If the English common law principles provide that English law would look to the law governing an arrangement to determine its characterisation, then such principles would provide that US Federal law is recognised as the governing law of the Statutory Trust by an English court and would also govern its characterisation. However, we set out in paragraph 3.3.2 of this Section II our analysis if the English common law principles provide that English law would determine the characterisation of the Statutory Trust instead.

**3.3** Application of the definition and features of a trust under English law to the Agent-Trust and Statutory Trust

**3.3.1** Applying the characteristics of a trust under English law discussed in paragraph 3.1.6 of this Section II above to the Agent-Trust, the following observations can be made:

(i) the FCM holds legal title to the Customer Transactions credited to a Customer Account;[18]

(ii) the Customer is the beneficial owner (i.e. the owner in equity) of the Customer Transactions credited to the Omnibus Customer Positions Account, being entitled to the benefit and subject to the burden of the Customer Transactions;[19]

(iii) Customer Transactions are identified by way of book-keeping records of the FCM as belonging to each Customer;[20]

(iv) Customer Transactions do not form part of the FCM's estate on insolvency;[21]

(v) after the default of a Customer (and in certain non-default circumstances set out in the Clearing Agreement as well), although the FCM may deal with Customer Transactions without regard to the directions of the Customer, the proceeds arising from the Customer Transactions

[18] Section III(A), page 9 of the S&C Memorandum.

[19] Section III(A), page 9 of the S&C Memorandum.

[20] See our assumption in respect of this point at paragraph 6.10 of Section I above.

[21] Section III(A)(4)(b), page 39 of the S&C Memorandum.

immediately become part of the Segregated Funds and the FCM must account to the Customer for its entitlement in respect of the Segregated Funds;[22] and

(vi) the arrangement is "an agency relationship under which the Customer Transactions are held on a trust"[23] under New York law, which includes trust law concepts similar to those in England.

It appears from the above that the incidents of ownership of the Customer Transactions are split between the FCM and the Customer and, more broadly, the features of this split in incidents of ownership are consistent with the characteristics of a trust under English law set out above. Therefore, to the extent not covered by the Convention, an English court is likely to conclude that the Agent-Trust should be characterised as a trust arrangement under English law.

**3.3.2** Applying the same principles to the Statutory Trust, the following observations can be made:

(i) the FCM holds legal title to the Segregated Funds credited to the Segregated Funds Account;[24]

(ii) each Customer has a beneficial interest in the Segregated Funds held in the Segregated Funds Account to the extent of the Net Liquidating Equity;[25] and

(iii) Funds equivalent to the Net Liquidating Equity for each Customer are identified by way of book-keeping records of the FCM as belonging to such Customer;[26]

(iv) Segregated Funds are segregated from the FCM's assets (arguably, other than in respect of the Residual Interest the FCM maintains in the Segregated Funds Account to prevent under-segregation)[27];

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[22] Section III(B)(2)(b), page 62 of the S&C Memorandum.

[23] See footnote 44 and the related text in the S&C Memorandum.

[24] Section III(A)(8), page 53 of the S&C Memorandum. Notwithstanding that FCM holds legal title to the Segregated Funds, we understand that U.S. commodities regulations and bankruptcy law puts the Customer Funds beyond the reach of an FCM's creditors on an insolvency of the FCM.

[25] Section III(A)(4)(b), page 38 of the S&C Memorandum. We understand that the beneficial interest of each Customer in respect of the Segregated Funds is to the extent of its Net Liquidating Equity and if the Segregated Funds in the Segregated Funds Account exceeds the aggregate positive Net Liquidating Equities for Customers of the same account class having a beneficial interest in the Segregated Funds Account (but with no reduction for any negative Net Liquidating Equities that Customers may have), the FCM has a Residual Interest in the Segregated Funds and the terms of the Statutory Trust permits the FCM to withdraw funds from the Segregated Funds (including for its own proprietary uses) up to the value of that excess.

[26] See our assumption in respect of this point at paragraph 6.10 of Section I above.

[27] This is an exception to the requirement under the Segregation Rules for the FCM to maintain funds belonging to customers segregated from its own assets. The fact that the FCM's Residual Interest may be held in the same account as the Customer Funds does not preclude the characterisation of the arrangement as a trust provided that the other aspects of the arrangement point towards a trust. See *Re Lehman Brothers International (Europe)* [2009] EWHC 2545 (Ch) and *Re Lehman Brothers International (Europe)* [2010] EWHC 2914 (Ch). In addition, the FCM does not beneficially own any specific Segregated Funds relating to its Residual Interest, so it is equally arguable that the Segregated Funds are segregated from the FCM's assets.

(v) Segregated Funds do not form part of the FCM's estate on insolvency;[28]

(vi) after the default of a Customer, although the FCM may deal with Customer Funds without regard to the directions of the Customer, the FCM must account to the Customer for the Net Liquidating Equity;[29]

(vii) the arrangement is characterised as a trust relationship under U.S. federal law, which includes trust law concepts similar to those in England.

It appears from the above that the incidents of ownership of the Customer Funds are split between the FCM and the Customer and, more broadly, the features of this split in incidents of ownership are consistent with the definitions of a trust under English law set out above. Therefore, to the extent not covered by the RT Act, an English court is likely to conclude that the Statutory Trust should be characterised as a trust arrangement under English law.

**3.4** Conflict of laws analysis of the trust provisions of the U.S. Clearing Model

Following from the analysis above and on the basis of the assumptions, qualifications and reasoning in this Memorandum, in our view:

(i) the Agent-Trust and the Statutory Trust may fall within the RT Act;

(ii) if either the Agent-Trust or the Statutory Trust does not fall within the RT Act, if the governing law of the trust determines the characterisation and validity of the trust, this will be a matter of New York or U.S. Federal law and we understand that in such cases a valid trust exists under such laws; and

(iii) if either the Agent-Trust or the Statutory Trust does not fall within the RT Act and the governing law of the trust does not determine the characterisation of the trust, if this falls to be considered by an English court, this characterisation will be a matter of English law and both the Agent-Trust and the Statutory Trust would be recognised as trusts under English law, such that their governing law would determine their validity and we understand that in such cases a valid trust would be found to exist under such laws.

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[28] Section III(A)(4)(b), page 39 of the S&C Memorandum. We note that the S&C Memorandum states that whilst the CFTC asserts and several courts agreed that Customer Funds are not part of the bankruptcy estate of an FCM, "a number of courts struggled as to the treatment of customer property in the event of its FCM's failure". Note we have assumed that Customer Funds are not part of the bankruptcy estate in paragraph 6.13 of Section I. If this assumption is not correct, then the Statutory Trust may not fall within the definition of a "trust" under the Convention. To the extent that the governing law of the Statutory Trust determines its existence and validity, then paragraph 3.2.2 (iv) of this Section II applies. To the extent that English law determines the characterisation of the Statutory Trust, its recognition will be more nuanced, reflecting (a) the considerations in sub-paragraphs (i) to (iv), (vi) and (vii) of paragraph 3.3.2 of this Section II and (b) the reason why the customer funds form part of the bankruptcy estate of the FCM. Even if the assumption is not correct, sub-paragraphs (i) to (iv), (vi) and (vii) of paragraph 3.3.2 of this Section II would, in our view, be persuasive but with a confidence level dependent upon the reason in (b) above.

[29] Section III(C), pages 63 and 64 of the S&C Memorandum.

Therefore, if proceedings were brought before the English courts in respect of the Agent-Trust or the Statutory Trust and New York law or U.S. Federal law, as applicable, is pleaded and proved as a fact in accordance with English procedural and evidential rules, the choice of New York law or U.S. Federal law as the governing law of the Agent-Trust and the Statutory Trust, respectively, would be recognised in England and accordingly New York law or U.S. Federal law, as applicable, would govern the validity of the Agent-Trust and the Statutory Trust, respectively and matters affecting the nature of the interest of a Customer in the Trust Property.

The conclusion in this paragraph 3.4 is subject to the following exceptions (the "**Trust Foreign Law Exceptions**"):

(i) where the RT Act applies, the RT Act does not prevent the application of provisions of the law designated by the conflicts rules of the forum, in so far as those provisions cannot be derogated from by voluntary act, in certain areas related to trusts law;[30]

(ii) where the RT Act applies, the RT Act preserves the application of the mandatory rules of the forum which must be applied even to international situations, irrespective of conflict of laws;[31]

(iii) where the RT Act applies, the provisions of the RT Act may be disregarded when their application would be manifestly incompatible with public policy;[32]

(iv) where the RT Act does not apply[33], the English courts may not be restricted from applying overriding mandatory provisions of English law; and

(v) where the RT Act does not apply, if there is a provision of New York law or U.S. Federal law, as the case may be, that is manifestly incompatible with English public policy, it is possible that the English courts may not apply it.

**3.5** Application of the Trust Foreign Law Exceptions to the Agent-Trust and the Statutory Trust

It therefore falls to be considered whether the Agent-Trust and the Statutory Trust come within the scope of the Trust Foreign Law Exceptions.

Whilst there are a number of mandatory provisions that English law would apply in relation to trusts (for example, in relation to (i) the transfer of title to trust property and the creation of security interests over trust property where the *situs* of the trust property is England and (ii) the protection, in other respects, of third parties acting in good faith

[30] Article 15 of the Schedule to the RT Act.

[31] Article 16 of the Schedule to the RT Act.

[32] Article 18 of the Schedule to the RT Act.

[33] In which case, English common law conflict of law rules apply.

where the third party is located in England), none of these provisions are directly relevant to the factual circumstances we have been asked to address. Mandatory provisions of English law that apply following commencement of insolvency proceedings are considered in paragraph 4 of this Section II below. Whether the Agent-Trust and the Statutory Trust give rise to a security interest subject to mandatory registration requirements is considered in paragraph 5.2 of this Section II.

In respect of the Trust Foreign Law Exception described in paragraphs 3.4(iii) and (v) above, it is necessary to consider whether application of all or any of the trust provisions constitute a penalty as a matter of English law. The two elements of the test in *Cavendish Square Holding BV v Talal El Makdessi*[34] are discussed in paragraph 2.2 of this Section II. In our opinion, the provisions of the Agent-Trust and the Statutory Trust would not be considered a secondary obligation or to not have a relation to the legitimate interests of an innocent party and so would not constitute a penalty. Therefore, we do not believe that the trust provisions of the Agent-Trust and the Statutory Trust described in the Summary Annex would be manifestly incompatible with English public policy.

Therefore, we consider that (subject to the discussion in paragraph 4 of this Section II) none of the Trust Foreign Law Exceptions apply and so New York law would be recognised as the governing law of the Agent-Trust and U.S. Federal law would be recognised as the governing law of the Statutory Trust.

**3.6** Risk of characterisation as a security interest under English law

Notwithstanding the discussion in paragraph 3.3 of this Section II above, it might be argued that there are certain similarities between the Agent-Trust and Statutory Trust arrangements under the U.S. Clearing Model and a security arrangement under English law and so we analyse whether an English court may characterise those arrangements as creating a security interest.

A security interest is created when a party ("**Party A**") grants another party ("**Party B**") a specifically enforceable right in the relevant property of Party A to secure the payment or discharge of a debt or other obligation owed by Party A to Party B and the relevant property is given as security only, not by way of outright transfer. The right is by way of grant of an interest in the debtor's asset, not by way of reservation of title to the creditor.[35]

In the case of *Re George Inglefield, Limited*, Romer LJ, although in the course of discussing the differences between a transaction of sale and a transaction of mortgage or charge, set out three basic non-exhaustive hallmarks of a security interest (which, notwithstanding the context of the case, may still be relevant to a determination by an English court of the substance of the Agent-Trust and the Statutory Trust):

(i) a security interest entitles the grantor of the interest to recover the subject property, before the security is enforced, by returning the money initially paid to

[34] [2015] UKSC 67.

[35] *McEntire v Crossley Bros* [1895] A.C. 457.

the grantor by the holder of the security interest. This right is the "equity of redemption";

(ii) if on the sale of property the subject of a security interest by the holder of such interest, the proceeds are more than is required to discharge the relevant secured obligations, the surplus must be returned to the grantor of the security interest; and

(iii) conversely, if property the subject of a security interest realises on sale less than is required to discharge the relevant secured obligations, the grantor of the security interest remains liable for the shortfall.[36]

The S&C Memorandum concludes that the Agent-Trust and Statutory Trust arrangements are trusts as a matter of U.S. law, the Customer's beneficial interests in which are subsequently subject to a security interest. Contrary to this however, it might be argued that, viewed as a whole under English law, the Agent-Trust and the Statutory Trust are better characterised under English law as trusts that also simultaneously create a security interest in favour of the FCM over all or part of the Agent-Trust Property and Statutory Trust Property.[37] It has been acknowledged that a trust arrangement may also be characterised as a security arrangement under English law.[38]

In *Welsh Development Agency v Export Finance Co Ltd*[39], the Court of Appeal used a two-fold test to determine how an agreement should be characterised. First, the court must establish whether the documents constitute a sham intended to mask the true agreement of the parties. Second, the court must establish the proper legal characterisation of the actual legal relations between the parties.

We consider the potential for such recharacterisation in respect of the Agent-Trust and the Statutory Trust in further detail below.

**3.6.1** The Agent-Trust as a security interest

There are certain features of the Agent-Trust which are similar to the features of a security interest. These similarities could support an argument that the Agent-Trust, as a matter of English law, creates a security interest in favour of the FCM over the Customer Transactions, as opposed to being a trust with a separate

[36] [1933] Ch 1 (CA) 27-28.

[37] We understand from the Summary Annex that the terms of the Clearing Agreement purport to grant to the FCM a security interest over the Customer Transactions and Customer Funds and not the Customer's *interest* in the Agent-Trust and the Statutory Trust, which may lead to the arrangement being construed as a trust and a simultaneous security interest in favour of the FCM. For the reasons set out above however, we do not think English courts would construe the arrangements as such.

[38] A number of cases have shown that where a person ("**Person A**") transfers property to another person ("**Person B**") and Person B is declared to hold the property on trust for Person A in order to protect Person A against the insolvency of Person B, acting as the trustee, such trust may be recharacterised as the creation of security by Person B. See *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd.* [1976] 1 WLR 676, *Hendy Lennox (Industrial Engines) Ltd v Grahame Puttick Ltd* [1984] 2 All ER 152 and *In re Bond Worth Ltd.* [1980] 1 Ch. 228. The issue being considered in this Memorandum is, of course, the opposite, in that the arrangement under consideration is the protection of Party B (the FCM) against the insolvency of Party A (the Customer) and not the converse.

[39] [1992] BCLC 148 (CA).

security interest over the Customer's beneficial interest in the Agent-Trust (as set out in the S&C Memorandum and the Summary Annex). They are as follows:

(i) the Customer gives the FCM certain rights in respect of the Customer Transactions for the purposes of collateralising the Customer's obligations to the FCM; and

(ii) there are certain restrictions on how the FCM is entitled to deal with the Customer Transactions, as (except in certain circumstances stipulated in the Clearing Agreement) the FCM acts as an agent of the Customer respect of the Clearing Transactions and is therefore required to act upon the instructions of the Customer.

However, notwithstanding these similarities, legal title to the Customer Transactions is held by the FCM from the moment that a Customer Transaction is established with the DCO – at no time does the Customer hold legal or beneficial title to a Customer Transaction. As soon as the Customer Transactions are entered into, they form part of the Agent-Trust Property held by the FCM and whilst the Customer has a beneficial interest in the Agent-Trust Property as a whole, the Customer does not have a beneficial interest in any specific Customer Transaction or a beneficial interest in the Customer Transactions outside the Agent-Trust. Having not previously held the legal title or the beneficial title to a particular Customer Transaction, the Customer could not, therefore, have created a security interest over the Customer Transactions.

In summary, whilst there are some common features between the Agent-Trust and a security interest under English law, the fact that the Customer does not hold the legal title or the beneficial title to a particular Customer Transaction before it becomes Agent-Trust Property is consistent with the recognition (under the Convention or common law) or characterisation (under the common law) by an English court of the Agent-Trust as a trust arrangement and inconsistent with its characterisation as a security interest. In our view, therefore, an English court would not characterise the Agent-Trust as a security arrangement in favour of the FCM over the Customer Transactions which constitute Agent-Trust Property.

**3.6.2** The Statutory Trust as a security interest

The similarities between the Statutory Trust and a security interest are the same as those between an Agent-Trust and a security interest, as set out above, except that the rights and restrictions are created over the Segregated Funds rather than the Customer Transactions and with the following additional features:

(i) there is a transfer of ownership of some assets from the Customer to the FCM when Customer Funds are delivered by the Customer to the FCM; and

(ii) one of the purposes for which Customer Funds are transferred from the Customer to the FCM is to collateralise amounts owed by the Customer to the FCM.

However, it is important to note that the Statutory Trust Property is not exclusively comprised of Customer Funds, but also includes the FCM's Residual Interest (which together constitute the Segregated Funds). As explained in paragraph 1.10 and footnote 14 of the Summary Annex, the FCM is required, pursuant to the segregation rules, to maintain its own funds (which may mean it is required to deposit its own funds) in the Segregated Funds Account (which are commingled with the Customer Funds) as a cushion of proprietary funds in order to protect against becoming undersegregated by failing to hold a sufficient amount of Segregated Funds to meet the CFTC's segregation requirement.

Such obligation of the FCM to deposit or maintain its own funds to the Segregated Funds Account is inconsistent with the creation of security by the Customer over the Segregated Funds because, whilst the Customer has a beneficial interest in the Statutory Trust Property as a whole, the Customer does not have a beneficial interest in any specific asset comprised in the Segregated Funds or a beneficial interest in the Segregated Funds outside the Statutory Trust. Having not previously held the legal title or the beneficial title to the proprietary funds of the FCM or funds transferred to the FCM by a DCO, the Customer could not, therefore, have created a security interest over the Segregated Funds. The existence of a Residual Interest is also more consistent with the characterisation of the arrangement as a trust than as a security interest.

*Characterisation of Permitted and Proprietary Uses*

Additionally, we understand from the S&C Memorandum and the Summary Annex that the FCM has, under the terms of the Clearing Agreement as well as the Statutory Trust, by way of operation of New York law and U.S. Federal law,[40] a right to withdraw funds from the Statutory Trust Property for certain purposes in the circumstances and manner described in the S&C Memorandum and paragraph 1.14 and footnote 20 of the Summary Annex.

These purposes fall broadly into two categories:

(a) Permitted Uses: The FCM is permitted to withdraw from segregation and apply Segregated Funds as necessary in the normal course of business to margin, guarantee, secure, transfer, adjust or settle a Customer's transactions with a DCO or another FCM, including to pay commissions, brokerage, interest, taxes, storage and other charges incurred in

[40] "*The FCM is entitled to take these actions to protect itself pursuant to the Customer Agreement, under general principles of industry and custom and usage, and in accordance with the other sources of law described*" at page 56. "*Even without the express authorization contained in the Customer Agreement, the Restatement (Second) of Agency provided that:*

*An agent whose principal violates or threatens to violate a contractual or restitutional duty to him has an appropriate remedy. He can, in a proper case … exercise the rights of a lien holder… Thus, the FCM would have the authority to take these measures, even in the absence of the provisions in the Customer Agreement"* at page 58.

"*Under both common law and (we assume) the Customer Agreement, as well as under Section 4 of the CEA, the FCM has the right, when accounting to its customer, to deduct any advances made from the balance of the customer account*" at page 70. "*The legislative history surrounding the adoption of the safe harbors for commodity contracts in the U.S. Bankruptcy Code supports the conclusions that both the industry and the sponsors of the safe harbors recognized an FCM's ability to enforce its lien against the customer account and set off amount following a customer default*" at page 71.

connection with that Customer's Customer Transactions. As noted in paragraph 2.14 of the Summary Annex, the Permitted Uses for which the FCM can withdraw funds directly from the Segregated Funds also includes some of the costs and expenses incurred during a Liquidation and in the exercise of its rights under the Clearing Agreement following a Customer's default.

(b) Proprietary Uses: Separately and as noted in paragraph 1.14 and footnote 20 of the Summary Annex, the Segregation Rules also permit the FCM to withdraw funds from the Segregated Funds for its own proprietary uses up to the value of its Residual Interest, subject to certain limitations ("**Proprietary Uses**"). If the FCM has paid expenses or incurred liabilities for purposes that do not fall within the range of Permitted Uses but may be properly charged to the Customer Account ("**Chargeable Costs**"), the FCM may not withdraw amounts directly from the Segregated Funds to meet Chargeable Costs. The FCM may, however, debit Chargeable Costs from the Customer's Account, which causes a corresponding reduction in the Customer's Net Liquidating Equity and a corresponding increase in the FCM's Residual Interest. We understand that the effect of this arrangement is to satisfy the Chargeable Costs (as they have been charged to the Customer Account) and increase the FCMs beneficial interest in the Statutory Trust (its Residual Interest), allowing the FCM to withdraw amounts from the Statutory Trust for Proprietary Uses, which amounts become the property of the FCM upon withdrawal.[41] The Residual Interest of the FCM in the Statutory Trust is structurally subordinate to each Customer's entitlement to the Net Liquidating Equity as it is determined by exhaustion once each Customer's Net Liquidating Equities have been determined. In our view, a Proprietary Use is analogous to the power of the FCM to return excess Customer Funds to a Customer and both effectively amount to the power of the FCM as trustee to allocate trust assets to or for the benefit of defined beneficiaries of a trust in accordance with the terms of the trust.

In the event of a Customer default, the FCM is entitled to effect a Liquidation. We understand and have assumed in paragraph 6.15 of Section I above that, in conducting a Liquidation, the FCM will only withdraw amounts from the Segregated Funds for Permitted Uses or Proprietary Uses. We need to consider what the proper characterisation of Permitted Uses and Proprietary Uses is under English law for the purposes of determining whether such characterisation raises any English law requirements for their validity.

As noted earlier, Permitted Uses are those purposes that entitle the FCM to use the Segregated Funds directly to discharge permitted costs and expenses of the Statutory Trust rather than having first to discharge these costs and expenses

[41] A right to a Proprietary Use may also arise for other reasons, such as when an FCM contributes its own assets to the Segregated Fund to cover a Customer's negative net liquidating equity, which is then then made good by the Customer.

out of its own resources and seek reimbursement from the Customer or the Statutory Trust. We understand that the FCM's right or power to apply such amounts exists under the terms of the Statutory Trust and is not considered to amount to the enforcement of a security interest under applicable U.S. law. In our view, Permitted Uses equates to a conventional power of a trustee to deal with trust assets in the administration of a trust and it would not therefore, be characterised as a security interest.

We also need to consider whether the FCM's right to charge Chargeable Costs to the Customer Account, coupled with an entitlement the FCM to withdraw the Segregated Funds for Proprietary Uses, amounts to a security interest under English law. In our view, it does not. As noted previously, a security interest involves the creation of a proprietary interest in an asset owned by Party A in favour of Party B to secure a liability of Party A to Party B. When the liability is discharged, Party A is entitled to the return of the asset by virtue of the equity of redemption. In the context of the Statutory Trust, the state of the Customer Account is determinative of the Customer's beneficial interest in the Statutory Trust.[42] There is no liability for the Customer Funds to secure and an entitlement to Customer Funds only exists when the Customer Account has a positive balance.

Further, the fact that the terms of the Statutory Trust do not secure any specific or particular obligation of the Customer to the FCM[43] strengthens this argument. It is clear from the above analysis that the terms of the Statutory Trust permit the FCM to apply Statutory Trust Property comprised in the Statutory Trust to enable the FCM to perform its obligations incurred in connection with the Transactions, which are held on the Agent-Trust or for its own proprietary uses. The purpose of the Statutory Trust is therefore, to enable the FCM to use the Statutory Trust Property either for the purpose of administering the Statutory Trust or for allocating the Statutory Trust to or for the benefit of defined beneficiaries of the Statutory Trust in accordance with the terms of the Statutory Trust. This analysis is consistent with the recognition (under the RT Act or English common law) or characterisation (under the English common law) by an English court of the Statutory Trust as a trust arrangement, with the Permitted Uses and Proprietary Uses each forming party of such a trust arrangement, and inconsistent with the characterisation of any of the Statutory Trust, Permitted Uses or Proprietary Uses as a security interest. In our view, therefore, an English court would not characterise the arrangements under the Statutory Trust as a security arrangement in favour of the FCM over the Segregated Funds which constitute the trust property.

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[42] We understand from the S&C Memorandum and the Summary Annex that the legal nature of the arrangement to withdraw funds from the Segregated Account for Permitted or Proprietary Uses is such that it is determinative of Customer's and the FCM's entitlement in respect of the Statutory Trust and not an encumbrance on the Statutory Trust Property.

[43] On the other hand, the Agent-Trust Security and Statutory Trust Security Interest do create security over the Agent-Trust Beneficial Interest and Statutory Trust Beneficial Interest for liabilities incurred under the Clearing Agreement.

## 4 Analysis of the U.S. Clearing Model following the commencement of insolvency proceedings in respect of the Customer

We note that the liquidation provisions of the U.S. Clearing Model may apply following the default of a Customer both before and after the commencement of insolvency proceedings in respect of the Customer. The analysis in paragraphs 2 and 3 of this Section II considers the position before the commencement of insolvency proceedings. If English insolvency proceedings are commenced in respect of the Customer, the analysis in paragraphs 2 and 3 of this Section II will continue to apply.

### 4.1 General Insolvency Principles and Statutory Avoidance Provisions

If English insolvency proceedings are commenced in respect of the Customer, the question arises as to whether certain transactions which took place before or after the commencement of liquidation or administration of the Customer might be affected by reason of the General Insolvency Principles or the Statutory Avoidance Provisions (as defined below). Before analysing the Statutory Avoidance Provisions and the General Insolvency Principles in greater detail, we set out the context in which these rules may be applied.

The General Insolvency Principles and the Statutory Avoidance Provisions apply to transactions entered into by an English company. However, a Customer is not a party to the Transactions, which are entered into on a principal-to-principal basis between the FCM and the DCO. Upon a default of a Customer, the liquidation of Customer Transactions (and any related positions) is effected in accordance with the Clearing Agreement, including the rules of each relevant DCO. In effecting this liquidation, the FCM will be closing out and entering into contractual arrangements and transactions with DCOs and other third parties as permitted by the Clearing Agreement. The Customer will not be closing out or entering into such contractual arrangements and transactions.

As noted in paragraph 1.5 of the Summary Annex, there are no separate transactions as between the Customer and the FCM. Rather, there is an overall duty of the FCM to account to the Customer for the net amount due under the terms of the Agent-Trust and the Statutory Trust. On the assumption that New York law and U.S. Federal law provide that a Customer's beneficial interest in the Agent-Trust Property or the Statutory Trust Property is not an interest in any specific asset that constitutes the Statutory Trust or the Agent-Trust but rather is a beneficial interest in the relevant Trust Property as a whole[44], English law would not treat the Customer as having an ownership right in any specific item of the Agent-Trust Property or Statutory Trust Property outright[45].

Each of the Statutory Avoidance Provisions and General Insolvency Principles are set out below and analysed in the context of the U.S. Clearing Model.

The immediately following sub-paragraphs (i), (ii) and (iii) set out certain insolvency

[44] See the assumption in paragraph 6.14 of Section I.

[45] *Stephenson (Inspector of Taxes) v Barclays Bank Trust Co. Ltd.* [1975] 1 W.L.R. 882.

provisions relevant to the analysis, and together, they constitute the "**General Insolvency Principles**".

Taking the General Insolvency Principles in turn:

(i) the mandatory insolvency set-off rules[46], which apply to mutual credits and debits of an insolvent entity provide a set mechanic and procedure for ensuring, provided certain requirements are met, that a party's various dealings with its counterparty will be set off against each other following the winding-up or administration of that counterparty. The rules are automatic and self-executing[47]. They will not however be relevant to the liquidation of the Agent-Trust Property and Statutory Trust Property by an FCM following the commencement of insolvency proceedings in respect of a Customer because following the liquidation of Customer Transactions by the FCM, any gains or losses resulting from the liquidation will be reflected in the Net Liquidating Equity of the Customer and a single net amount is determined which represents the Customer's Statutory Trust entitlement. Whilst this may appear to be a form of netting or set-off, in relation to the Clearing Agreement, the Customer only ever has an entitlement to this single net amount. This represents a determination of the overall value of the single course of dealing between the FCM and the Customer rather the exercise of set off in respect of a number of different transactions – there are no distinct transactions or obligations that are separate from the proprietary interest of the Customer in the Agent-Trust Property or the Statutory Trust Property;

(ii) on a voluntary winding-up of a company under English law, section 107 of the Insolvency Act provides for the satisfaction of the company's liabilities by the application of the company's property in favour of the company's creditors on a *pari passu* basis (subject to the satisfaction of any preferential claims). There is no equivalent provision relating to a compulsory winding-up under English law. However, Rule 14.12 of the Insolvency Rules states that debts, other than preferential debts, rank equally between themselves. Under English law, the parties to an agreement cannot contract out of this *pari passu* rule.[48] It could be argued that the application by the FCM of the Statutory Trust Property to Permitted Uses or Proprietary Uses following the commencement of insolvency proceedings in respect of the Customer where other creditors of the Customer do not recover amounts owed to them in full, would contravene the *pari passu* rule. We understand however, that under applicable U.S. law the Permitted Uses and Proprietary Uses are an inherent element of the Statutory Trust and, in the case of Permitted Uses, rank ahead of (because it is determinative of) the Customer's interests in the Statutory Trust Property (see our discussion in respect of Permitted Uses in paragraph 3.6 of this Section II) and, in the context

[46] These are currently enshrined, in relation to a liquidation, in Rule 14.25 of the Insolvency Rules, and, in relation to administrations, in Rule 14.24 of the Insolvency Rules.

[47] *Stein v Blake* [1995] 2 All ER 961.

[48] *British Eagle International Airlines Limited v Compagnie Nationale Air France* [1975] 2 All ER 390.

of Proprietary Uses, only arises when the FCM has a Residual Interest in the Statutory Trust and so does not involve the allocation of property belonging to the company. The Customer's interest in the Statutory Trust Property is, therefore, subject to the FCM's right to withdraw funds for Permitted Uses and Proprietary Uses;

(iii) the anti-deprivation rule is a separate, but parallel, principle to the *pari passu* rule which states that a person cannot agree that their property will be forfeited or transferred to another, or confiscated, on their insolvency. Similarly, any provisions to the effect that amounts payable by the insolvent party under a contract are increased upon insolvency are unenforceable. The anti-deprivation rule would only be relevant in the context of the U.S. Clearing Model if, on the insolvency of a Customer, the terms on which Customer Transactions are liquidated meant that there was some form of deprivation (e.g. Transactions are taken away from the FCM for no value or a reduced value so as to deprive the Customer's interest in the Agent-Trust Property or Statutory Trust Property of value). As set out in the Summary Annex, following a default by the Customer, the FCM designates a liquidation date and brings about the liquidation of Customer Transactions by way of entering into certain transactions with the DCO (namely, Offsetting Transactions, Sale/Novation Transactions, Replacement Transactions, Risk-reducing Transactions or Mitigation Transactions and/or any other transaction entered into in order to effect a Futures Liquidation or a Cleared Derivatives Liquidation (if any)). Following the determination of the associated costs (or gains) resulting from the entry into of these transactions the FCM determines an aggregate net amount payable in connection with the liquidation (which may include its own properly incurred costs and expenses). This liquidation process would not be considered to be a deprivation as there is no property which is forfeited or confiscated or amount payable increased – the liquidation process simply produces a single net amount after the deduction of all costs, expenses and liabilities incurred by the FCM for the account of the Customer that are properly chargeable to the Customer, which is reflected in balance of the Customer Account and represents the Customer's entitlement in respect of the Statutory Trust Property (being the Net Liquidating Equity), which, in any case, is the extent of Customer's beneficial interest in the Statutory Trust Property at any point. The anti-deprivation rule was considered in the Supreme Court case of *Belmont Park*[49] where it was held that a "common sense application" of the rule was required in each case. The judgments in *Belmont Park* propose that the correct approach is essentially one of analysing whether or not the arrangements are designed improperly to get around the insolvency principles. The starting point is that a "*deliberate intention to evade the insolvency laws is required*"[50]. This is not a purely purposive test – "*that does not mean of course that a subjective intention is required, or that there will not be*

[49] [2011] UKSC 38.

[50] At paragraph 78.

*cases so obvious that an intention can be inferred*". But "*a commercially sensible transaction entered into in good faith should not be held to infringe the anti-deprivation rule*"[51]. "*The Court has to make an objective assessment of the purpose and effect of the relevant transaction or provision in bankruptcy, when considering whether it amounts to an illegitimate evasion of the bankruptcy law or has a legitimate commercial basis in other considerations*"[52]. It was also clear that the courts will be slow to strike down "*a complex commercial transaction entered in good faith*"[53]. We have assumed[54] that the arrangements under the U.S. Clearing Model are entered into for *bona fide* commercial reasons and our understanding is that they are not intended to evade insolvency principles. Consequently, we consider that the arrangements under the U.S. Clearing Model do not contravene the anti-deprivation rule,

The immediately following sub-paragraphs (i) to (vi) set out certain statutory insolvency principles relevant to the analysis, and together, they constitute the "**Statutory Avoidance** Provisions".

Taking the applicable Statutory Avoidance Provisions in turn[55]:

(i) under section 127 of the Insolvency Act, if a company makes a disposition of assets after the date of commencement of its winding-up, then such transaction shall be void unless the court orders otherwise. For these purposes the date of commencement of the winding-up is deemed to be the date of the petition for a winding-up by the court. If the FCM liquidates the Customer Transactions following the commencement of the winding-up of the Customer, or withdraws amounts from the Segregated Funds for Permitted or Proprietary Uses, this could be argued to be a breach of section 127 of the Insolvency Act. However, the Customer's trust entitlement is to the Net Liquidating Equity as described in the Summary Annex. The Customer does not have an interest in any specific Customer Transaction or Statutory Trust Property and the Residual Interest constitutes the FCM's own funds, and so none of the liquidation of a Customer Transaction and the withdrawal of funds by the FCM for Permitted Purposes or Proprietary Purposes could be regarded as the disposition of an asset of the Customer;

(ii) under section 178 of the Insolvency Act, a liquidator may disclaim any onerous property, which is essentially any unprofitable contract or property which is not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act. As the Customer is not party to the Transactions, which are entered into between the FCM and a DCO, they could not be

[51] At paragraph 79.

[52] At paragraph 151.

[53] At paragraph 109.

[54] See paragraph 6.6 of Section I.

[55] We note that Regulation 10 of the FC Regulations disapplies some of the statutory avoidance provisions (most notably sections 127 and 178 of the Insolvency Act). However, the FC Regulations will not apply to trust arrangements and, as discussed in paragraph 5.1.4 of Section II, may not apply to the Security Interest.

considered as "onerous property" of the Customer and could not, therefore, be disclaimed. The only contract that could be disclaimed is the Clearing Agreement and it is not possible to disclaim a part of it.

(iii) under section 238 of the Insolvency Act, a transaction entered into by a company which at such time was unable to pay its debts within the meaning of section 123 of the Insolvency Act or became unable to pay its debts within the meaning of that Section in consequence of that transaction, may be set aside by an English court if it determines that the transaction is at an undervalue (and certain other requirements are satisfied). A transaction at an undervalue is one under which the company either receives no consideration or receives consideration the value of which is "significantly less" than the value of the consideration provided by the company. It should be noted, however, that section 238 expressly provides that the court shall not make any such order if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business and that, at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company. As discussed in sub-paragraph (ii) above, the Customer does not enter into the Transactions and so they could not be considered to be at an undervalue as regards the Customer. In the unlikely event that the transfer of Customer Funds from the Customer to the FCM is considered by an English court to be a transaction, we believe that the exemption discussed above (in relation to the transaction being entered into in good faith, for the purpose of carrying on the Customer's business and for the benefit of the Customer) would apply;

(iv) under section 239 of the Insolvency Act, if an insolvent company does anything or suffers anything to be done which has the effect of putting a creditor into a position which, in the event of the company going into insolvent liquidation, would be better than the position that person would have been in if that thing had not been done, then there may be a voidable preference. However, a court cannot make an order under that section 239 unless the company was influenced in deciding to give the preference by a desire to put that person in such better position. We have assumed in paragraph 6.5 of Section II above that the Transactions are entered into for *bona fide* commercial reasons so that section 239 would not apply even were it to apply to Transactions to which the Customer is not a party. We understand and assume that the transfer of Customer Funds by the Customer is not influenced by the desire to put the FCM into a better position but, rather, reflects the operation of the Clearing Agreement, the applicable rules of the DCO, the Agent-Trust and the Statutory Trust in accordance with their terms;

(v) section 244 of the Insolvency Act provides that where a transaction to which a company is, or has been, a party for or involving the provision of credit to the company is held to be "extortionate" (as explained below) the court may set aside any obligation created thereunder (in whole or in part), including those of sureties, and can amend any term of the transaction and any security executed

in connection with it. The court can also require either party to the transaction to make repayments under it. For these purposes a transaction is extortionate if, having regard to the risk accepted by the person providing the credit, (a) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit or (b) it otherwise grossly contravened ordinary principles of fair dealing. As the Customer is not a party to the Transactions, section 244 cannot apply to them. We understand and assume that the transfer of Customer Funds by the Customer to the FCM would not be held to be extortionate, but, rather, reflects the operation of the Clearing Agreement, the Agent-Trust and the Statutory Trust in accordance with their terms; and

(vi) under section 423 of the Insolvency Act, if a transaction is, at the time, entered into at an undervalue for the purpose of putting the assets of a company beyond the reach of a creditor or prospective creditor or otherwise prejudicing the interests of the creditor or prospective creditor, the court may make such an order as it thinks fit for restoring the position to what it would have been if the transaction had not been entered into and protecting the interests of the victims of the transaction. As the Customer is not a party to the Transactions, section 423 cannot apply to them. We understand and assume that the transfer of Customer Funds by the Customer to the FCM is not at an undervalue and is not intended to put assets of the Customer beyond the reach of a creditor or prospective creditor or otherwise prejudicing the interests of the creditor or prospective creditor, but, rather, reflects the operation of the Clearing Agreement, the Agent-Trust and the Statutory Trust in accordance with their terms,

Our analysis above applies equally to the equivalent Statutory Avoidance Provisions introduced under the Banking Act and the Investment Bank Regulations.

Accordingly, on the basis of the assumptions and analysis in this Memorandum, in our view neither the General Insolvency Principles nor the Statutory Avoidance Provisions apply to:

(i) the Transactions;

(ii) the various methods by which an FCM can bring about a Cleared Derivatives Liquidation and a Futures Liquidation (other than by way of enforcement of security, which is considered in paragraph 5.1 of this Section II); and

(iii) the Determination of Account, pursuant to which, following a Cleared Derivatives Liquidation and a Futures Liquidation, a single net amount is determined by the FCM, which forms part of the Customer's Statutory Trust entitlement.

**4.2** Foreign currency debts

It is also necessary to consider whether, in the event that the FCM determines the single net amount which is the Customer's Statutory Trust entitlement in a currency other than sterling, an English court would enforce a claim for such amount in such currency and

whether a claim for such amount can be proved in insolvency proceedings in England without conversion into sterling.

Rule 14.21 of the Insolvency Rules ("**Rule 14.21**") sets out the position in respect of foreign currency debts on the winding up or administration of a debtor. It states that "a proof for a debt incurred or payable in a foreign currency must state the amount of the debt in that currency. The office-holder must convert all such debts into sterling at a single rate for each currency determined by the office-holder by reference to the exchange rates prevailing on" the date on which the company entered administration or went into liquidation (as appropriate). This is because claims in an insolvency proceeding which is governed by English law must be made in sterling. Rule 14.21 does not specify which exchange rate is to be used. Creditors must however be informed of the exchange rate used and have a right of redress to the courts in the event that they consider the exchange rate unreasonable. If the court finds that the rate is unreasonable it may itself determine the exchange rate.[56]

These provisions will apply to any single net amount determined to be due from a Customer to the FCM and will not affect the liquidation mechanics of the Clearing Agreement.

## 5 Security Interest and Permitted Uses

**5.1** Security interest under the Clearing Agreement

In addition and separate to the Agent-Trust and Statutory Trust, under the terms of the Clearing Agreement, the Customer grants to the FCM a security interest governed by New York law in the Customer Funds and the Customer Transactions. As a matter of strict legal interpretation, given that the FCM as trustee has legal title to the Customer Funds and the Customer Transactions, we understand that as a matter of New York law this is likely to amount to security over all the Customer's rights in respect of the Customer Funds and the Customer Transactions, which, given that the Customer Funds and the Customer Transactions form part of the Statutory Trust Property and Agent-Trust Property, respectively, which are each held on trust for the Customer, will be security over the Customer's beneficial interest under the specific Statutory Trust in respect of the Customer Funds and the beneficial interest in the Agent-Trust over the Customer Transactions as opposed to creating security over the assets constituting the relevant Trust Property themselves. The Security Interest secures liabilities of the Customer to the FCM that arise in connection with the Customer Agreement. However, there is little reason for the FCM to enforce the Security Interest, as the manner in which the contractual and trust arrangements are structured under the Clearing Agreement (as described in paragraphs 2.6, 2.10 and 2.12- 2.15 of the Summary Annex) entitles the FCM to liquidate the Customer Transactions and deduct amounts to cover liabilities,

[56] Note that if the FC Regulations apply, Rule 14.21 will be displaced by Regulation 14 of the FC Regulations which provides, broadly, that the specific provisions in a financial collateral arrangement regarding the currency in which obligations are to be calculated and the rate of any currency conversions will be effective, unless the rate set through the arrangement is unreasonable.

costs or expenses it has incurred in connection with the Customer Transactions and the liquidation process using its contractual and statutory rights, without any need to enforce the security interest. That said, we also understand the Security Interest serves the additional purpose in the U.S. of preventing third parties from gaining an intervening interest or otherwise interfering in the Customer Transactions or Customer Funds, or in the FCM's rights to any proceeds realised from them.

As set out in the Summary Annex, following a Customer's default, the FCM is entitled to enforce the Security Interest, in addition to liquidating the Customer's positions and determining the net amount in respect of which the FCM or Customer will have a duty to account to the other party.[57]

**5.1.1** Nature of the Security Interest

The Security Interest is granted in the form of a New York law security interest in favour of the FCM by the Customer. It is therefore necessary to consider whether the Security Interest is effective, as a matter of New York law, to create rights for the FCM which English law would recognise as being in the form of a security interest.

Under English law, as discussed in paragraph 3.6 above, a security arrangement creates in favour of the collateral-taker a security interest in an asset on terms that the security interest will be discharged once the collateral-provider has performed the collateralised obligation.

We understand and have assumed that, as a matter of New York law, the Clearing Agreement is effective to create an interest of this nature in favour of the FCM. On this basis it is likely that the English courts would consider that the Security Interest creates rights which are in the nature of a security interest as understood under English law. The type of English law security interest which those New York law rights would equate to is beyond the scope of this opinion as we do not have any information about the precise terms of the security agreement or arrangement under which the Security Interest is created.[58]

We now consider the effectiveness of the Security Interest.

**5.1.2** Pre-insolvency enforcement of the Security Interest

If English insolvency proceedings have not been commenced in respect of the Customer, the relevant issue to consider is whether the choice of New York law

[57] However, we understand that this option is not used by the FCM in practice, in preference to using its contractual and statutory rights under the Clearing Agreement to liquidate the Customer Transactions and determine the net entitlement of the Customer. Therefore, we do not examine this in further detail here.

[58] Under English law, a security interest can be fixed or floating in nature. It is important to note that the fixed or floating characterisation of a security interest does not depend on the terminology used by the parties and will instead depend on the legal characterisation of the arrangement based on the contractual rights and obligations of the parties. The characterisation of a security interest as floating security is likely to be detrimental to the collateral-taker since (contrary to the position in respect of a fixed security interest) its security will rank behind various competing claims on the collateral-provider's insolvency, enforcement may be affected in the event of the collateral-provider entering into administration and in some cases the floating charge can be rendered partly or completely void under the Insolvency Act.

as the governing law of the Security Interest would be recognised under English law.

As a general principle of English contract law, the parties are (prior to the commencement of insolvency proceedings) free to agree the terms on which they contract, including the circumstances in which one party creates security for the benefit of the other party. If proceedings were brought before the English courts in respect of the Security Interest and New York law is pleaded and proved as a fact in accordance with English procedural and evidential rules, the choice of New York law as the governing law of the Security Interest would be recognised in England and, accordingly, New York law would govern the validity, binding effect and enforceability of the Security Interest. This general principle is subject to the Contractual Foreign Law Exceptions set out in paragraph 2.1 of this Section II.

*Application of the Contractual Foreign Law Exceptions to the Security Interest*

It is necessary to consider whether the Security Interest comes within the scope of the Contractual Foreign Law Exceptions. For the same reasons as set out in paragraph 2.1 of this Section II, the Contractual Foreign Law Exceptions described in paragraphs 2.1(i) to 2.1(iv) will not apply and it is the Contractual Foreign Law Exceptions in paragraphs (v) and (vi) – that mandatory provisions of English law may override a provision of New York law and that English courts may not apply a provision of New York law that is manifestly incompatible with English public policy – that require the substantive English law analysis.

(i) Public policy override

In respect of the Contractual Foreign Law Exception described in paragraph (v) of this Section II, we do not believe that the Security Interest created under the Clearing Agreement would be manifestly incompatible with English public policy.

(ii) Mandatory provisions of English law

In respect of the Contractual Foreign Law Exception described in paragraph (vi) of this Section II, English law contains certain mandatory registration requirements for "charges" registrable under Section 59A of the Companies Act. We think it is probable that the Security Interest would be considered a charge for these purposes and as a result the Security Interest should be registered in accordance with the following requirements of the Companies Act (except to the extent the Security Interest is exclusively over assets that constitute "financial collateral" and the Security Interest constitutes a "financial collateral arrangement", in each case within the meaning of the FC Regulations, as to which see paragraph 5.1.5 of this Section II):

(a) a statement of particulars, meeting certain requirements, relating to the charge (in this case, the New York law pledge) created by the Customer must be delivered to the registrar;[59]

(b) a certified copy of the instrument creating or evidencing the charge must be delivered to the registrar (a copy of the instrument will subsequently be publicly available); and

(c) the period allowed for delivery of these documents is 21 days beginning with the day after the date the charge was created, unless an order allowing an extended period is made.

If a charge is created and the relevant documents are not delivered to the registrar in the prescribed timeframe and in the prescribed manner the charge will be void against a liquidator, administrator or creditor (meaning creditors in a winding-up or administration and secured creditors, as opposed to unsecured creditors where no winding-up or administration has occurred) of the company[60] and the money[61] secured by the charge which is void will become immediately payable.[62]

**5.1.3** Post insolvency enforcement of the Security Interest

Upon an insolvency of the Customer, it is necessary to consider whether the Security Interest would also be effective as against a liquidator, administrator or creditor of the

[59] In practice, all the information required to be included in the statement of particulars will be delivered to the registrar in a Form MR01.

[60] Companies Act, Section 859H.

[61] The effect of this provision in practice in the context of cleared derivatives is unclear. Section 859H(4) of the Companies Act, by its construction, is restricted to situations in which the charge secures an obligation for the repayment of money. A derivatives transaction may involve the payment of money but it is unlikely to involve the *repayment* of money. This reflects the central case in which registrable charges are used, which is to secure borrowings, and it appears to be these which the draftsperson had in mind when constructing the provision. A question then arises as to whether the provision must be construed as having a similar result where a charge secures other obligations. A credible argument can be put forward that Section 859H(4) should be taken at face value and limited to obligations for the repayment of money. There is an important conceptual difference between an obligation for the repayment of money and the types of obligation that arise under a typical derivatives contract – in the former case, the debt accrues unconditionally (i.e. it is due) as soon as the money has been advanced, even if the money is not payable until a later date. In the case of an obligation to pay money under a derivatives contract, the debt is generally not immediately due but is dependent on something else happening. It therefore makes sense to refer to an obligation for the payment of money immediately becoming payable. The same is not true of an obligation which has not accrued. For such an obligation to become immediately payable not only would the obligation have to be accelerated but any conditions to the accrual of the debt would have to be deemed to be satisfied. This would have profound and unintended consequences on the economics of certain transactions (such as those with obligations subject to a contingency). This interpretation may however be viewed as too restrictive and, indeed, create an odd policy position where security fails for lack of registration to protect simple lenders but not anyone else. A court may take a purposive approach and construe the wording in Section 859H(4) in such a way that gives protection to the secured creditor in respect of a liability under a derivatives transaction similar to the protection for a simple debt, although this would require some creativity by the court. Assuming that liabilities under a derivatives transaction are accelerated in the event of non-registration, there is yet further uncertainty as to what the acceleration of liabilities will actually entail (i.e. exactly which future potential payments are accelerated and how valuations are determined), particularly in the context of a Clearing Agreement which relates to the arrangements between an FCM and a Customer, rather than the derivatives transactions themselves.

[62] Although it is unclear when the repayment obligation arises, the view taken by many commentators is that the money becomes repayable at the end of the 21 day period as it would defeat the whole purpose of the provision if the chargee had no immediate right to repayment having been deprived of its security.

Customer. Other than the considerations already discussed, relating to the public policy override and the registration requirements in paragraph 5.1.2 of this Section II, the key consideration is that of a possible moratorium on enforcement action by creditors. However, the analysis in this paragraph 5.1.3 is applicable only to the arrangements in the Clearing Agreement if the Security Interest does not fall within the scope of the FC Regulations. The applicability of the FC Regulations, which creates a beneficial regime for certain types of collateral arrangements, to the Security Interest is analysed in paragraph 5.1.5 below.

In the absence of the FC Regulations, whilst there is no general prohibition on a creditor enforcing its security over the assets of a company in an English liquidation, generally upon an administration of a Customer under English law, any enforcement of security relating to an asset of the Customer would be prohibited under English law by the administration moratorium[63].

The administration moratorium prevents, except with the consent of the court or the administrator, amongst other things: (i) the passing of any winding-up resolution or making of any winding-up order; (ii) the taking of any steps to enforce any security against the company and (iii) the commencement or continuance of any legal process against the company or its assets. When deciding whether to give or refuse consent the administrator or the court must balance the interests of the enforcing creditor and the wider requirements of the administration. If enforcement would not prejudice the achievement of the purpose, then it will usually be permitted.

With limited exceptions, the restrictions take effect when the application for an administration order is made, or the notice of intention to appoint an administrator out-of-court by notice is filed, rather than when the appointment is made. Once an administration has commenced the moratorium will continue until the administration is completed. Note that the moratorium does not in fact affect the substantive rights of the parties. The legal right of the secured party to enforce their security, and the causes of action based on such rights, remain vested in the secured party. The secured party is just not at liberty to enforce those rights during the administration.

**5.1.4** Application of the FC Regulations

However, to the extent the FC Regulations are determined to be applicable to the Security Interest, they would override the registration requirements set out in paragraph 5.1.2 of this Section II above and the statutory provisions which prevent the enforcement of security interests when a company is subject to an administration moratorium.

For the FC Regulations to apply to the Security Interest, the arrangements must constitute a “title transfer financial collateral arrangement” or a “security financial collateral arrangement” under the FC Regulations.

As set out in the Summary Annex and as discussed in paragraph 5.1 of this Section II above, we understand that pursuant to the terms of the Clearing Agreement a security

[63] The relevant statutory provisions relating to the administration moratorium are set out in Schedule B1 of the Insolvency Act as supplemented by Part 3 of the Insolvency (England and Wales) Rules 2016 (SI 2016/1024).

interest (in the form of a New York security interest) is created over both the Agent-Trust Beneficial Interest and Statutory Trust Beneficial Interest which would be recognised as a security interest under English law. Accordingly, the analysis in paragraph 5.1.5 only considers whether the Security Interest constitutes a "security financial collateral arrangement" within the meaning of the FC Regulations. It should, however, be noted that a number of the provisions of the FC Regulations have not been the subject of extensive consideration by the English courts and so our opinion in relation to such provisions is largely based on our interpretation of the FC Regulations in the absence of detailed judicial or regulatory guidance on these provisions.

**5.1.5** Analysis of FC Regulations

A "security financial collateral arrangement" is defined in the FC Regulations as being:

*"an agreement or arrangement, evidenced in writing, where:*

*(a) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker;*

*(b) the collateral-provider creates or there arises a security interest in financial collateral to secure those obligations;*

*(c) the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf; any right of the collateral-provider to substitute financial collateral of the same or greater value or withdraw excess financial collateral or to collect the proceeds of credit claims until further notice shall not prevent the financial collateral being in the possession or under the control of the collateral-taker; and*

*(d) the collateral-provider and the collateral-taker are both non-natural persons."*

In order for the Security Interest to be a "security financial collateral arrangement", it must therefore satisfy all elements of the definition set out above. We consider paragraph (b) of this definition below:

"*Security interest in financial collateral*" – The collateral-provider (i.e. the Customer) must create, or there must arise, a "security interest" in "financial collateral". Taking each of these requirements in turn:

(a) "*security interest*" - A "security interest" is defined in the FC Regulations as:

"*any legal or equitable interest or any right in security … created or otherwise arising by way of security including –*

(a) *a pledge;*

(a) *a mortgage;*

(b) *a fixed charge;*

(c) *a charge created as a floating charge … ; or*

(d) *a lien*".

(b) "*Financial collateral*" – The security interest must be over "financial collateral". The FC Regulations define "financial collateral" as "*cash, financial instruments or credit claims*" where "*financial instruments*" are in turn defined as:

*(a)* "*shares in companies and other securities equivalent to shares in companies;*

*(b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradeable on the capital market; and*

*(c) any other securities which are normally dealt in and which give the right to acquire such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payments);*

*and includes units of a collective investment scheme within the meaning of the Financial Services and Markets Act 2000, eligible debt securities within the meaning of the Uncertificated Securities Regulations 2001, money market instruments, claims relating to or rights in or in respect of any of the financial instruments included in this definition and any rights, privileges or benefits attached to or arising from any such financial instruments*"; and

The Security Interest secures two types of assets:

(i) the Customer's beneficial interest in the Segregated Funds – which (on the basis of our assumption in paragraph 6.11 of Section I above) does fall within the definition of a "financial instrument" set out above; and

(ii) the Customer's beneficial interest in the Customer Transactions – which does not fall within the definition of a "financial instrument" set out above.

In respect of paragraph (i) above, we understand and have assumed (as noted in paragraph 6.11 of Section I above) that the type of non-cash assets secured by the Security Interest are "financial instruments" of the types described above, which may include certain shares which the Customer holds in other companies or certain debt securities. Though the Customer secures their beneficial interest in such property (as opposed to the property itself), this subject matter of the security may still constitute a "financial instrument" nonetheless, since the definition of "financial instruments" includes "*claims relating to or rights in or in respect of*" any of the financial instruments included in the definition, which would include financial instruments that are held on trust. We also note that the definition of "financial instruments" is broad, and includes shares in companies and any instruments giving rise to or acknowledging indebtedness (which in

our opinion would also include debt securities, assuming they are tradeable on the capital markets).

In respect of paragraph (ii) above, rights in respect of contracts (such as the Customer Transactions) are not included within the definition of "financial collateral".

Notwithstanding that part of the assets secured by the Security Interest may constitute financial collateral, if some assets do not and a single security interest is created over the entire pool of assets, the Security Interest may not constitute a "security financial collateral arrangement" under the FC Regulations unless it is clear that the security can be severed into separate security arrangements, one constituting a security financial collateral arrangement and the other not.[64]

Although it may be possible to include separate security arrangements in the Clearing Agreement – one, over the Segregated Funds, which may constitute a security financial collateral arrangement, and one over the Customer Transactions, which is not a security financial collateral arrangement (and therefore registrable) – the entire Clearing Agreement would nonetheless be registrable[65] (as a result of the security arrangement over the Customer Transactions being registrable)[66] and thereby publicly available. In order to avoid the Clearing Agreement becoming publicly available, the registrable charge in respect of the Customer Transactions would need to be set out in a charging document separate to the Clearing Agreement. Only this separate charging document would in that case be publicly available following registration and not the entire Clearing Agreement (on the assumption that the charge over the Segregated Funds satisfies the other requirements of a security financial collateral arrangement). Any enforcement of the registrable charge would, as discussed in paragraph 5.1.3 of this Section II, be subject to the administration moratorium.

**5.2** Enforceability of the provisions permitting withdrawals for Permitted Uses and Proprietary Uses

**5.2.1** Enforceability pre-insolvency

[64] It is inherent from paragraph (b) of "security financial collateral arrangement" that a security interest is only capable of constituting such an arrangement where (leaving aside the various other requirements) it is over "financial collateral". It does not necessarily follow from this requirement that a single agreement cannot contain a combination of arrangements, where one of them is a "security financial collateral arrangement" and the others are not. However, if a single agreement is to contain a combination of arrangements, it is necessary that the arrangement which is intended to be a "security financial collateral arrangement" is either fully segregated from or legally capable of being severable from the other arrangements so that a court can determine which security constitutes a security financial collateral arrangement and which does not.

[65] Although the obligation under the Companies Act to register charges is imposed on the chargor, a chargee is also permitted to register the charge. This is typically what happens in practice, as the adverse effects of a failure to register the charge (mainly, that the charge is rendered void) falls primarily upon the chargee. It is important to note however, that if the chargee fails to register the charge or elects not to register it, this does not absolve the chargor of its obligation to register the charge. The chargor remains under an obligation under the Companies Act to register an agreement containing a registrable charge.

[66] For the avoidance of doubt, the fact that the entire Clearing Agreement is "registrable" does not mean that its non-registration would necessarily result in the security being void in respect of both the Segregated Funds and Customer Transactions. If the grant of a security interest over assets that constitute financial collateral (such that it constitutes a "security financial collateral arrangement") is legally severable or clearly drafted to be separate from the grant of security over non-financial collateral, such that a court can clearly distinguish between the two, then only the security arrangement in respect of non-financial collateral may be void.

Withdrawals for both Permitted Uses and Proprietary Uses, discussed in paragraph 3.6 of this Section II, form part of the arrangements under the Clearing Agreement, in respect of which we have already discussed the Trust Foreign Law Exceptions in paragraph 3.5 of this Section II. The only additional mandatory provision of English law which needs to be considered in this context is whether the mandatory registration requirements of the Companies Act (as are discussed in the context of the Security Interest in paragraph 5.1 of this Section II above) apply to them. As discussed in paragraph 3.6 and based on the assumptions and reasoning therein, in our view, neither Permitted Uses nor Proprietary Uses would be considered under English law as a form of security interest and so would not be subject to the mandatory security registration requirements.

**5.2.2** Enforceability post-insolvency

Upon an insolvency of the Customer, it is necessary to consider whether the enforceability of the provisions permitting withdrawals for Permitted Uses and Proprietary Uses would be affected by the General Insolvency Provisions and the Statutory Avoidance Provisions. The analysis in paragraph 4 of this Section II already considers these issues, where relevant, in respect of Permitted Uses and Proprietary Uses. Similar to the Security Interest, an additional consideration is whether their enforcement by the FCM would be prohibited under English law by an administration moratorium. The effect of an administration moratorium is discussed in paragraph 5.1.3 of this Section II. An administration moratorium will only prevent their enforcement if the steps taken by an FCM following a Customer default described in paragraph 3.6 of this Section II are determined to be the "taking of steps to enforce security". The Insolvency Act defines "security" as "any mortgage, charge, lien or other security".[67] As discussed in paragraph 3.6 and based on the assumptions and reasoning therein, neither Permitted Uses nor Proprietary Uses would be considered under English law as a form of security interest and so would not be subject to the administration moratorium.

## 6 Operation of the U.S. Clearing Model under English law

On the basis of the analysis in paragraphs 3, 4 and 5 of this Section II and assuming that the Agent-Trust and Statutory Trust are valid, binding and enforceable under New York law, there is no reason[68] so far as English law is concerned why, in any action in the English courts where New York law or U.S. Federal law as the governing law of the Agent-Trust and Statutory Trust, respectively, are pleaded and proved, the Agent-Trust and Statutory Trust would not be enforceable both before and after the commencement of insolvency proceedings in respect of the Customer. As a consequence and on the assumption that New York law and U.S. Federal law so provide and subject to the assumptions, qualifications and reasoning elsewhere in this Memorandum:

(i) English law should not affect the right of the FCM as a trustee and as a contractual counterparty to the Customer to deal with the Agent-Trust Property and Statutory Trust

[68] This statement is made on the assumption that Permitted and Non-Permitted Uses would not be considered under English law as a form of security interest, as to which, see our discussion in paragraphs 3.6 and 5.2.

Property in accordance with the contractual and trust arrangements agreed (or implied) between the FCM and a Customer and/or as specified by statute, as described in the Summary Annex;

(ii) the assets held by the FCM in the Omnibus Customer Positions Account, the Customer Account and the Segregated Funds Account and the liabilities incurred by the FCM in the course of performing its obligations or exercising its rights under the Clearing Agreement will not be treated under English law as assets or liabilities of the Customer, but as assets and liabilities of the FCM in its capacity as principal, agent-trustee or trustee (as the case may be)[69] that (in the case of assets) are ultimately held on trust for the Customer under the terms of the Agent-Trust, and the Customer and the FCM (to the extent of the Residual Interest) under the terms of the Statutory Trust;

(iii) English law should not affect the various methods by which an FCM can bring about the liquidation of a Customer's Futures Transaction and Cleared Derivatives Transactions, as set out in paragraphs 2.6 and 2.10 of the Summary Annex;

(iv) English law should not affect the Determination of Account, pursuant to which, following the liquidation of all Customer Transactions, a single net amount is determined by the FCM after the deduction of any costs and expenses incurred in connection with the liquidation of Customer Transactions or during the course of acting as the Customer's FCM that are permitted by the Segregation Rules, which is reflected in the balance of the Customer Account and represents the Net Liquidating Equity that is the Customer's net entitlement under the Clearing Agreement; and

(v) English law should not affect the exercise by the FCM of its rights in respect of Permitted and Proprietary Uses.

[69] However, we note that liabilities incurred by the FCM in its capacity as agent-trustee or trustee are not limited in recourse to the Agent-Trust Property and Statutory Trust Property.

## III. ISSUES

In this Section III we address the questions contained in your Instructions. Each question is set out in italics followed by our response.

The definitions for the following terms used in this Section III are below:

"**Collateral Security Interest**" means the security interest granted by the Customer to the FCM over the Trust Assets;

"**Cleared Derivatives Liquidation Rights**" means the different methods and processes (as set out in paragraph 2.6 of the Summary Annex) by which an FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a Customer's Cleared Derivatives Transactions;

"**Covered Base Agreement**" means a futures customer account agreement;

"**CDA**" means an addendum for Cleared Derivatives Transactions in the form published by FIA and ISDA in 2012 or 2018;

"**Event of Default**" means an event of default (whether or not described as an "event of default") contained within a Covered Base Agreement or a CDA;

"**Futures Liquidation Rights**" the different methods and processes (as set out in paragraphs 2.10 of the Summary Annex) by which an FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a customer's Futures Transactions;

"**Futures Transactions**" means transactions for the purchase or sale of commodities for future delivery on, or subject to the rules of, a derivatives clearing organization registered as such under the United States Commodity Exchange Act or traded on, or subject to the rules of, a board of trade outside the United States and/or options thereon subject to Part 33 of the rules of the CFTC;

"**Liquidation Rights**" means the Cleared Derivatives Liquidation Rights and the Future Liquidation Rights;

"**Trust Assets**" means the Agent-Trust Property and Statutory Trust Property as defined in Section I of this Memorandum;

"**Trust Beneficial Interest**" means the Agent-Trust Beneficial Interest and the Statutory Trust Beneficial Interest as defined in Section I of this Memorandum;

"**Trust and Contractual Liquidation Rights**" means the exercise by the FCM of its Liquidation Rights in reliance on its contractual and trust entitlement under the Covered Base Agreement and/or the CDA (which does not need to involve the enforcement of any security interests); and

"**Trust Security Interest**" means the Security Interest as defined in Section I of this Memorandum.

## 1 Recognition and Operation of the U.S. Trusts and Exercise of the Trust Liquidation Rights

**1.1** ***Question 1: Would the parties' agreement on governing law of each Covered Base Agreement and CDA and submission to jurisdiction be upheld in your jurisdiction, and what would be the consequences if they were not?***

Please see our discussion in respect of this point in paragraphs 2.2 and 3.5 of Section II above.

If the parties' agreement on the governing law and their submission to jurisdiction were not upheld (although we believe it would), the Covered Base Agreement and CDA would be examined on the basis of the law determined to be most applicable by an English court.

**1.2** ***Question 2: Would each of the methods by which an FCM can bring about the liquidation of a customer's Futures Transactions and Cleared Derivatives Transactions (i.e. the Cleared Derivatives Liquidation Rights), as set out in paragraphs 2.6 and 2.10 of the Summary Annex, be recognized and upheld under your jurisdiction. If a particular method would either not be upheld or may be challenged, please provide further detail and explain the reason for this.***

Yes, subject to and as discussed in Section II above, on the basis that the Agent-Trust and Statutory Trust would be recognised under English law as trusts and New York law (in the case of the Agent-Trust) or U.S. Federal law (in the case of the Statutory Trust) would govern the validity, interpretation and effect of the trusts, the liquidation methods set out in paragraphs 2.6 and 2.10 of the Summary Annex as supplemented by paragraphs 2.12 to 2.15 of the Summary Annex would be recognised and upheld by English courts.

**1.3** ***Question 3: Would the "Agent-Trust" and Statutory Trust be recognized and upheld under the laws of your jurisdiction as creating a valid trust over the relevant customer transactions and assets whereby the FCM holds the legal title to the relevant customer transactions and assets and the customer holds a beneficial interest in the trust as a whole (as opposed to maintaining an interest in any specific assets under the trust)?***

Yes, subject to and as discussed in Section II above, English law would recognise and characterise the Agent-Trust and the Statutory Trust as trusts as a matter of English law over the Customer Transactions and the Segregated Funds, respectively, where the FCM acts as trustee and the Customer a beneficiary.

On the assumption that as a matter of New York law a beneficiary's interest in respect of the Agent-Trust Property or the Statutory Trust Property is in the relevant Trust Property as a whole (i.e. the Customer's beneficial interest in the relevant Trust Property is an interest in a proportionate share of each asset constituting the relevant Trust Property) and not in any specific asset that may at a particular point in time constitute part of the trust property, this will be recognised under English law, which would not treat the Customer as having an ownership right in any specific item of the relevant Trust Property outright. Furthermore, English law recognises that the assets constituting trust property may change from time to time.

**1.4** ***Question 4: Would the exercise by the FCM of its Trust and Contractual Liquidation Rights (including the operation of the Determination of Account), upon the occurrence of an***

***Event of Default in respect of a customer, be recognized and upheld under the laws of your jurisdiction?***

Yes, as set out in paragraph 6 of Section II (and subject to the discussion in Section II), there is no reason so far as English law is concerned why, in any action in the English courts where New York law or U.S. Federal law as the governing law of the Agent-Trust and Statutory Trust, respectively, are pleaded and proved, the Agent-Trust and Statutory Trust would not be enforceable both before and after the commencement of insolvency proceedings in respect of the Customer, including in respect of the exercise of the Trust Liquidation Rights and the operation of the Determination of Account.

**1.5** ***Question 5: Is there any risk that either the "Agent-Trust" or the Statutory Trust would be recharacterised under your jurisdiction (e.g. as security)? If so, how would the exercise by the FCM of its Trust Liquidation Rights be characterised under the laws of your jurisdiction?***

Please see our discussion on this point in paragraph 3.6 of Section II above.

**1.6** ***Question 6: Under your jurisdiction, are any rights or processes available to a creditor of a customer by which such creditor could make a claim against the customer assets held on the Statutory Trust or against the Futures Transactions and Cleared Derivatives Transactions (and any rights in respect thereof) held on the "Agent-Trust" by the FCM for the benefit of the customer as opposed to only having recourse to the single net amount that constitutes the Determination of Account?***

No, on the assumption that as a matter of New York law a beneficiary's interest in respect of the Agent-Trust Property or the Statutory Trust Property (as the case may be) is in the relevant Trust Property as a whole (i.e. the Customer's beneficial interest in the Agent-Trust Property or the Statutory Trust Property (as the case may be) is an interest in a proportionate share of each asset constituting the relevant Trust Property) and not in any specific asset that may at a particular point in time constitute part of the relevant Trust Property, this will be recognised under English law, which would not treat the Customer as having an ownership right in any specific item of the relevant Trust Property outright. As a result, a creditor of a Customer will only be entitled to claim against the single net amount that constitutes the Determination of Account and not any specific asset that may constitute the relevant Trust Property.

**1.7** ***Question 7: Assuming the parties have entered into a Covered Base Agreement and CDA, the customer is insolvent and the FCM has determined a lump-sum termination amount in a currency other than the currency of the jurisdiction in which the insolvent customer is organized:***

**1.7.1** ***would a court in your jurisdiction enforce a claim for the net termination amount in the currency in which it was determined?***

**1.7.2** ***can a claim for the net termination amount be proved in insolvency proceedings in your jurisdiction without conversion into the local currency?***

***If in either case the claim must be converted to local currency for purposes of enforcement or proof in insolvency proceedings, please set out the rules governing the timing and exchange rate for such conversion.***

Please see our discussion on this point in paragraph 4.2 of Section II above.

**1.8** ***Question 8: Are there any other local law considerations that you would recommend the FCM to consider in connection with the exercise of the Trust and Contractual Liquidation Rights (including the operation of the Determination of Account)?***

No, subject to the discussion set out in Section II above.

In addition, we would advise that in the event of a Customer default, the FCM rely on and exercise the Trust and Contractual Liquidation Rights in preference to the Enforcement Liquidation Rights. As discussed in paragraph 5.1.3 of Section II above, in respect of a security interest which does not fall within the scope of the FC Regulations, whilst there is no general prohibition on a creditor enforcing its security over the assets of a company in an English liquidation, generally upon an administration of an English Customer, any enforcement of security relating to an asset of the Customer would be prohibited under English law by the administration moratorium, unless the security is a security financial collateral arrangement, in respect of which, see paragraphs 5.1.4 and 5.1.5. There is no similar restriction that would be applicable in respect of the exercise of the Trust and Contractual Liquidation Rights.

**1.9** ***Question 9: Are there any other circumstances you can foresee that might affect the FCM's ability to exercise the Trust and Contractual Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction?***

No, subject to the discussion set out in Section II above.

**1.10** ***Question 10: Assuming that the FCM's ability to exercise the Trust and Contractual Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction will be recognized in your jurisdiction, will such rights be capable of exercise without recourse to or enforcement of the Trust Security Interest or any Collateral Security Interest?***

Yes, the FCM will not need to have recourse to or enforce the Trust Security Interest or any Collateral Security Interest in order to exercise the Trust and Contractual Liquidation Rights (including the operation of the Determination of Account).

## 2 Enforceability of the Security Interest and Exercise of the Enforcement Liquidation Rights

**2.1** ***Question 1: Would the security interest granted by the customer to the FCM be recognized under your jurisdiction as creating a security interest over the customer's Trust Beneficial Interest in the form of a Trust Security Interest or, alternatively, as creating a security interest directly over the Trust Assets themselves in the form of a Collateral Security Interest as described immediately before question 13 below?***

As discussed in paragraphs 5.1 of Section II, the Security Interest granted by the Customer to the FCM will be recognised as a security interest over the Customer's Trust Beneficial Interest in the form of a Trust Security Interest and not over the Trust Assets themselves in the form of a Collateral Security Interest.

**2.2** ***Question 2: In respect of the security interest created, as set out in your answer to question 1 above, are there any local law consequences of the creation of such security interest that should be considered and may affect the arrangements between the FCM and its customers? In particular, are there any provisions under local law that may render such security interest void (for example, as a result of non-compliance with registration formalities) and therefore cause the money secured by the security interest to become immediately payable?***

Yes, if a security interest in the form of a charge is created and the relevant documents are not delivered to the registrar in the prescribed timeframe and in the prescribed manner as required under English law, the charge will be void against a liquidator, administrator or creditor (meaning creditors in a winding-up or administration and secured creditors, as opposed to unsecured creditors where no winding-up or administration has occurred) of the company and the money secured by the charge which is void will become immediately payable[70]. The enforcement of the charge may also be subject to a moratorium during administration. The above does not apply if the charge is a "security financial collateral arrangement" pursuant to the FC Regulations. Please see our discussion on these topics in paragraphs 5.1 of Section II.

[70] As to which, see footnote 61.

## IV. Qualifications and reliance

### 1 Qualifications

**1.1** We express no opinion on any provision of the Clearing Agreement or any provision set out in the Summary Annex save for those provisions that we expressly opine upon in this Memorandum.

**1.2** The term "**enforceable**" as used in this Memorandum means that the obligations assumed by the relevant party under the relevant document are of a type which the English courts enforce. It does not mean that those obligations will necessarily be enforced in all circumstances in accordance with their terms.

**1.3** Enforcement may be limited by general principles of equity – for example, in England, remedies such as specific performance and injunction may not be available.

**1.4** An English court may not give effect to any contractual provision concerning payment of the costs of enforcement or litigation brought before an English court.

**1.5** We have not reviewed any of the terms of the Transactions entered into, or to be entered into, between the FCM, the Customer and the DCO and express no opinion on them.

**1.6** The analysis in this Memorandum is restricted to the position where the relevant insolvency proceedings in respect of the Customer are governed by English law. We express no opinion as to whether English law would, in fact, govern such proceedings, whether or not conducted in the English courts.

**1.7** Claims may become barred under the Limitation Act 1980 or may be or become subject to set-off or counterclaim.

**1.8** We are not qualified to give, and have not given, accounting or auditing advice and nothing in this Memorandum is to be interpreted otherwise.

**1.9** A certificate, determination, valuation, notification, opinion or the like might be held by the English courts not to be conclusive, final or binding if it could be shown to have an unreasonable or arbitrary basis or in the event of manifest error despite any provision in the relevant Clearing Agreement (or the DCO rules that it is subject to) to the contrary.

**1.10** Any provision of the relevant Clearing Agreement (or the DCO rules that it is subject to) which constitutes, or purports to constitute, a restriction on the exercise of any statutory power may be ineffective.

**1.11** The effectiveness of terms exculpating a party from a liability or from a duty otherwise owed may be limited by law or regulation.

**1.12** Any provision of the relevant Clearing Agreement (or the DCO rules that it is subject to) stating that a failure or delay on the part of any party in exercising any right or remedy shall not operate as a waiver of such right or remedy may not be effective.

**1.13** Any prohibition of bringing, instituting or joining insolvency proceedings in relation to any party

is subject to the following qualifications:

(a) it is possible that an English court would deal with an insolvency proceeding even if it had been presented in breach of contract; and

(b) there may be no entitlement to damages as a result of such breach (as such insolvency proceeding may not itself be the cause of the relevant loss).

**1.14** We do not express any opinion as to any taxation matters.

**1.15** An English court may, or may be required to, stay proceedings or decline jurisdiction in certain circumstances - for example, if proceedings are brought elsewhere.

**1.16** The Banking Act provides for a special resolution regime (the "**SRR**") which gives substantial power to Her Majesty's Treasury, the Bank of England, the Financial Conduct Authority and the Prudential Regulation Authority (together, or individually, as applicable, the "**Authorities**") to deal with and stabilise banks, banking group companies, investment firms and CCPs (though not investment banks, unless also one of the aforementioned) if they are in financial difficulties. As part of the SRR under Part 1 of the Banking Act, the Authorities may utilise five stabilisation options which are contained in Sections 11 to 13 (inclusive) of Part 1 of the Banking Act (the "**Stabilisation Options**"). This is a consequence of the implementation of the BRRD, as a result of which the Banking Act and the FC Regulations were amended in a way which imposes a number of restrictions on the ability of a party to terminate its contractual arrangements with an entity which is subject to an exercise of one of the Stabilisation Options, or action taken thereunder.[71] These restrictions are as follows:

**1.16.1** Section 48Z of the Banking Act provides that an exercise of one of the Stabilisation Options, and the occurrence of any event directly linked to that exercise, are to be ignored in determining whether a contractual right to terminate a contract has arisen. The effect of Section 48Z of the Banking Act is therefore to disapply any contractual termination rights which arise expressly by reference to an exercise of a Stabilisation Option, as well as any which arise by reference to the consequences of such an exercise (for example a right to terminate on a change of control or a disposal of assets). However, Section 48Z of the Banking Act does not disapply contractual termination rights which arise other than through an exercise of a Stabilisation Option (for example through a *factual* insolvency or through a change of control or disposal of assets which occurs other than as a result of an exercise of a Stabilisation Option);

**1.16.2** Section 70A(1) of the Banking Act allows the Authorities to suspend obligations to make payments or deliveries under any contract (not just "qualifying contracts" described in

[71] The stabilisation options consist of (i) a sale of all or part of a business to a private sector purchaser (Section 11), (ii) a transfer of all or part of a business to a bridge bank (Section 12), (iii) a transfer of all or part of a business to an asset management vehicle (Section 12ZA), (iv) the bailing-in of certain liabilities (Section 12A) and (v) temporary public ownership (Section 13). We note that the transfer of property powers expressly contemplate transfers of property held on trust (however arising). The Banking Act provides that a property transfer instrument may make provisions about "*(a) the terms on which the property is to be held after the instrument takes effect, and (b) how any powers, provisions and liabilities in respect of the property are to be exercisable or have effect after the instrument takes effect*". The power under paragraph (a) "*may remove or alter the terms of the trust on which the property is held only to the extent that the Bank of England thinks it necessary or expedient for the purpose of transferring – (a) the legal or beneficial interest of the transferor in the property; (b) any powers, rights or obligations of the transferor in respect of the property*".

paragraph (ii) above). If exercised by the Authorities, the suspension power must end by no later than midnight on the first business day after the suspension takes effect (i.e. the suspension may only last for up to two working days), with the suspended obligations becoming performable once again at the end of the suspension period. The purpose of Section 70A(1) of the Banking Act seems to be to give the Authorities flexibility to prevent termination from occurring (even where there is a payment/delivery default) by suspending the payment/delivery obligations for a short period pending resolution;

**1.16.3** Section 70B of the Banking Act allows the Authorities to temporarily suspend the rights of a secured creditor to enforce any "security interest" in relation to assets of an entity subject to SRR. The term "security interest" is broadly defined and means an interest or right held for the purposes of securing a payment or performance obligation. As with the temporary suspension on payment and delivery obligations described in the paragraph above, the exemptions to the suspension are unlikely to apply, although the temporary suspension period is limited in time as described above;

**1.16.4** Section 70C(1) of the Banking Act allows the Authorities to suspend a termination right of any party (other than, amongst others, central counterparties and central banks) to a "qualifying contract". A "qualifying contract" is defined as any contract where one of the parties is subject to the exercise of a Stabilisation Option and all the obligations under the contract to make payments, deliveries or to provide collateral continue to be performed. The effect of Section 70C(1) of the Banking Act is therefore that the Authorities can suspend termination rights (beyond those disapplied under Section 48Z of the Banking Act) provided that there is no payment/delivery default under the contract (as opposed to some other default, such as the commencement of insolvency proceedings); and

**1.16.5** Section 70C(6) of the Banking Act also provides that any suspension of termination rights by the Authorities under Section 70C(1) of the Banking Act must end by no later than midnight on the first business day after the suspension takes effect (i.e. the suspension may only last for up to two working days) and Section 70C(7) of the Banking Act allows the exercise of termination rights during the suspension period where the Authorities gives notice that the relevant contracts will not be subject to an exercise of a Stabilisation Option. Sections 70C(8) and (9) of the Banking Act provide that, once the suspension period has ended, termination rights become exercisable once again (provided that they have arisen other than through the use of a Stabilisation Option or a suspension under Section 70C(1) of the Banking Act) and, where the contract has been transferred pursuant to an exercise of a Stabilisation Option, only if the termination right has been triggered by the transferee entity. The intention behind Sections 70C(8) and (9) of the Banking Act therefore seems to be that, once the suspension period has ended, the parties' termination rights are as they would have been but for the exercise of a Stabilisation Option.

**1.17** The ability (through the use of certain of the Stabilisation Options) to transfer some, but not all, of the assets of a failing bank (or investment firm or banking group company) to a new entity (i.e. creating a "good entity" and a "bad entity") was a key policy objective of the Banking Act. The assets could include property outside the UK and rights and liabilities governed by foreign law.

Protection has, however, been afforded for secured liabilities by the Banking Act 2009 (Restriction of Partial Property Transfers) Order, the Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order and the Banking Act 2009 (Banking Group Companies) Order 2014 (together, the "**Banking Act Safeguard Orders**").[72] The Banking Act Safeguard Orders provide that where a liability is secured against property or rights, a partial property transfer may not (i) transfer the property or rights against which the liability is secured unless that liability and the benefit of the security are also transferred or (ii) transfer the benefit of the security unless the liability which is secured is also transferred. Accordingly, in our opinion, the liabilities of the Customer would not be split from the assets over which the Security Interest is created in favour of the FCM under a partial property transfer.

**1.18** The UK has implemented the "bail-in" provisions derived from the Banking Resolution and Recovery Directive (the "**BRRD**")[73] by changes to the Banking Act which took effect as from 1 January 2015. The bail-in provisions (which apply to banks, banking group companies and investment firms) effectively allow for:

(i) claims of creditors to be to be reduced, cancelled or modified (including by changing the form of liabilities through amendment to contracts and instruments) as necessary to restore an institution to financial viability; and/or

(ii) the transfer of shares and liabilities of an institution including to a bail-in administrator (temporarily) or another third party (e.g. creditors who have suffered losses or a purchaser).

Certain liabilities are excluded (as "excluded liabilities") from the scope of bail-in under Section 48B(8) of the Banking Act, including secured liabilities. In our opinion, the liabilities of the Customer to the FCM under the Clearing Agreement will be excluded because they are secured liabilities as a result of the Security Interest.

**1.19** Part VII of FSMA provides for court-sanctioned transfers of the whole or part of the business carried out in the United Kingdom by certain banks and insurance companies. Pursuant to Section 112A of FSMA (as amended by the FSMA 2000 (Amendments to Part 7) Regulations 2008) contractual provisions which seek, inter alia, to terminate or modify any interest or right as a consequence of anything done or likely to be done under Part VII of FSMA are in effect suspended until after the court order sanctioning the transfer is approved, and are only thereafter effective to the extent not amended by that order. The termination and liquidation provisions under the Clearing Agreement would fall within the scope of these suspension and modification provisions, with the result that the FCM would not normally be able to exercise its rights under the Clearing Agreement before the making of the order. Notice of an application to the court for

[72] The protective provisions in respect of netting and set-off arrangements in the Banking Act Safeguards Orders do not expressly apply to banking group companies. However, Section 81C(2) of the Banking Act probably addresses the apparent lacuna in this context by providing that "[w]here the Bank of England exercises a stabilisation power in respect of a banking group company […], the provisions relating to the stabilisation powers and the bank administration procedure contained in this Act […] and any other enactment apply (with any necessary modifications) as if the banking group company were a bank". As the Banking Act Safeguards Orders are enactments relating to the stabilisation powers, this would suggest that their protective provisions will apply to banking group companies as they do to banks and investment firms. This would seem to be a sensible result, and consistent with the stated policy objectives of the government.

[73] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

an order under Part VII of FSMA is required to be published in the London Gazette and two national newspapers and is therefore likely to come to the FCM's attention. Any person who alleges that they would be adversely affected by the carrying out of the scheme has a right to be heard in the court proceedings which are required to approve any transfer. The FCM would, therefore, have the right to complain to the court before any transfer which would adversely affect its rights under the Clearing Agreement was implemented.

## 2 Addressees of this Memorandum, purpose and reliance

This Memorandum of law is addressed to the FIA and ISDA solely for their benefit and the benefit of their members in relation to their use of the Clearing Agreement. No other person may rely on this Memorandum for any purpose without our prior written consent. This Memorandum may, however, be shown by the FIA, ISDA, an FIA member or an ISDA member to a competent regulatory or supervisory authority or professional advisors for such member, the FIA or ISDA for the purposes of information only, on the basis that we assume no responsibility to such authority or any other person as a result, or otherwise.

Linklaters LLP

Linklaters LLP

# Annex 1

**Summary Annex**

*summarising the arrangements under the Clearing Agreement in respect of the Agent-Trust and Statutory Trust*

*The following is intended as a high-level overview and summary only of the main concepts covered, conclusions reached, and certain factual assumptions, in the Sullivan & Cromwell LLP memorandum entitled "Analysis of the Relationships Among Customers, FCMs and DCOs Under the U.S. Agency Clearing Model" dated 21 November 2018 (the "**S&C Memo**") and certain liquidation provisions under a Futures and Options Agreement and a Cleared Derivatives Addendum in order to assist with the interpretation of the S&C Memo. Counsel should not rely on this overview and summary as a substitute for reading the S&C Memo in full, as this overview and summary does not include the assumptions, qualifications and detailed reasoning set out in the S&C Memo.*[1]

## 1 Legal relationships between DCO, FCM and customer – pre-customer default

**1.1** Pursuant to the terms of a customer account agreement (the "**customer agreement**")[2], an FCM establishes one or more accounts in its books in the customer's name (with respect to any customer, its "**account**"), and the customer authorises or appoints the FCM (with the effect that the FCM is appointed to act as the customer's agent), to execute, carry and clear futures[3] and swap contracts (with respect to a customer**,** its "**contracts**" or **"transactions**") on behalf of the customer[4]. The customer agreement establishes (i) the scope and terms of the FCM's authority as agent as well as (ii) certain other contractual rights and obligations of the FCM and its customer relating to aspects of their relationship in which the FCM acts in a principal capacity as the customer's contractual counterparty and not as the customer's agent. The circumstances in which the FCM acts, or is permitted to act, in the capacity of a principal effectively operate to constrain the extent of the agency relationship in relation to the transactions.

**1.2** The customer agreement generally comprises: (i) in relation to a customer entering into only futures transactions, a futures customer account agreement (a "**Futures and Options Agreement**") and (ii) in relation to a customer entering into cleared swaps transactions only or both cleared swaps transactions and futures transactions, both a Futures and Options Agreement and a cleared derivatives addendum to the Futures and Options Agreement (a "**Cleared Derivatives Addendum**"). Although a customer agreement may comprise more than one document, it constitutes a single agreement that governs the operation of the customer's account.

*The FCM as agent-trustee with respect to transactions*

**1.3** Although the FCM enters into transactions upon the instruction and for the risk and benefit of the customer, the FCM's relationship with the DCO in relation to transactions is treated by the DCO as a principal-to-principal relationship and is governed by the terms of the DCO's rules and procedures, to which the customer is not a party. The customer is not in privity of contract with the DCO, the DCO has no liability to the customer and the customer has no

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[1] Note that in this overview and summary there are a number of references to "positions", which is terminology used in applicable law and market practice in relation to "transactions". The two terms are used broadly interchangeably in this overview and summary.

[2] A customer agreement will typically specify that the customer's account and its transactions are subject to "**applicable law**", which is generally defined to include applicable U.S. legislation, rules, regulations and interpretations of regulatory agencies and self-regulatory organizations ("**SROs**"), rules of clearing organizations, exchanges and other trading venues and customs, usages and practices of the futures and derivatives industry.

[3] For purposes of this overview and summary, the term "futures" means futures and options on futures that are executed on a contract market designated pursuant to Section 5 of the U.S. Commodity Exchange Act (as amended, the "**CEA**") and cleared by a clearing organization registered with the U.S. Commodity Futures Trading Commission (the "**CFTC**") as a derivatives clearing organization ("**DCO**").

[4] A customer agreement does not typically specify the DCOs through which an FCM clears the customer's transactions.

rights or claims against the DCO. The FCM is fully liable as principal for all amounts owing to the DCO in connection with the FCM's customer transactions. Such transactions are credited to the FCM's omnibus customer positions account (an "**omnibus customer positions account**") at the DCO maintained in the name of the FCM for the benefit of its customers in the relevant CFTC customer account class (which include, for purposes of this overview and summary, futures accounts and cleared swaps accounts), and, in the case of cleared swaps, further credited to a sub-account for the customer within such omnibus customer positions account.

**1.4** For every transaction, there are therefore two relevant accounts: (i) the customer's account in the FCM's books in the name of the customer to which all its transactions cleared by that FCM across all DCOs are credited and (ii) an omnibus customer positions account of the FCM at the applicable DCO to which the FCM's customer transactions for all its customers in the relevant CFTC customer account class at that DCO are credited.

**1.5** Under this arrangement, the FCM acts in the capacity of "agent-trustee" of the customer with respect to the transactions. This reflects that, as the sole counterparty to the contract made on the customer's behalf with a DCO, the FCM holds legal title to (i.e. it is the legal owner of) the transactions credited to the omnibus customer positions account maintained with the relevant DCO. The customer is, however, the beneficial owner (i.e. the owner in equity) of the transactions credited to the omnibus customer positions account, entitled to the benefit and subject to the burden of the transactions.[5] In other words, these transactions are held on a type of trust for each customer by the FCM (an "**agent-trust**")[6].[7] Each customer will have a beneficial interest in the agent-trust over all the transactions credited to its specific customer account, but will not have an interest in any specific transaction as such. Each agent-trust under which the FCM holds transactions on trust for a customer will be distinct from all other agent-trusts under which the FCM holds transactions on trust for its other customers.

**1.6** Under the customer agreement, the customer is typically required (i) to deposit and maintain margin with the FCM[8], (ii) to pay the FCM, among other things, the amount of any trading losses, debit balances or deficiencies (and any applicable interest thereon) in the customer's

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[5] Whilst it is true that the customer at any given point in time is the beneficial owner of the transactions recorded to the omnibus customer positions account under the agent-trust arrangement, this does not mean that the FCM has a duty to account to the customer for trading gains realised in respect of those transactions on a gross basis (or for the entirety of the transactions). See footnote 11 for a more detailed summary of the customer's entitlement against the FCM in relation to the agent-trust.

[6] Under U.S. common-law principles, the distinctions between agent, trustee and agent-trustee include (among other things) the following:

(i) an agent undertakes to act on behalf of the principal and subject to its control but an agent, as such, does not acquire title to the property of its principal (although an agent may have possession of, and be authorized to deal with, its principal's property);

(ii) a trustee has title to property that it holds subject to equitable duties to deal with it for the benefit of another, but is not subject to the control of the trust settlor or beneficiaries except to the extent the terms of the trust reserve or confer some such power over the trustee; and

(iii) an agent-trustee is an agent that has title to property that it agrees to hold for the benefit and subject to the control of its principal, resulting in a technical trust relationship, but one that is generally subject to rules of agency, not trust law.

[7] Notably however, as mentioned in paragraph 1.1 of this overview and summary, notwithstanding such agent-trust relationship being established under the customer agreement, the FCM retains a contractual right under the customer agreement, under certain circumstances specified in that agreement (including certain non-default scenarios), to liquidate the transactions in its capacity as a contractual counterparty to the customer (and not in its capacity as agent- trustee).

[8] In connection with establishing a position for a customer in a contract cleared by a DCO, the amount of initial margin for the position required by the FCM from the customer may exceed the amount of initial margin required by the DCO from the FCM. Margin provided by customers is described in greater detail in footnotes 16 and 18.

account, and brokerage charges and commissions owed to or incurred by the FCM, and fees, fines, penalties and other charges imposed by exchanges or other SROs, relating to any contract cleared for the customer or the customer's account and (iii) to reimburse or indemnify the FCM for any costs or liabilities incurred by the FCM in the course of providing services or exercising remedies under the customer agreement.

*The FCM as statutory trustee with respect to customer funds*

**1.7** Under the U.S. Commodity Exchange Act (as amended, the "**CEA**") and related CFTC regulations (collectively, the "**segregation rules**"), money, securities and other property (collectively, "**funds**") received from the customer by way of margin for, and all funds accruing to the customer as the result of, the customer's transactions ("**customer funds**" – see also the section headed "Net liquidating equity" in footnote 14) must be treated as "belonging to such customer". The segregation rules impose a duty to segregate customer funds and certain funds contributed by the FCM as described in paragraph 1.10 (together, the "**segregated funds**") and thereby establish a specific statutory trust over all segregated funds held by the FCM for the benefit of its customers (and to the extent of its residual interest, for its own benefit[9]) (the "**Statutory Trust**")[10]**.** The extent of the customer funds is defined by the segregation rules described in footnotes 10 and 14. This statutory trust, under which the FCM holds segregated funds, including the customer funds, is distinct from the common-law agent-trusts under which the FCM holds the transactions described above[11]. Again, however, this statutory trust is not a classic common-law trust and the duties of the FCM with respect to the statutory trust are determined by the segregation rules, not by common-law trust principles.

**1.8** This distinction is exemplified by certain arrangements which are permitted by the segregation rules but would not generally arise under a classic common-law trust. The segregation rules permit the FCM to invest customer funds in certain types of permitted

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[9] See the discussion regarding the FCM's residual interest in paragraph 1.10 of this overview and summary.

[10] The segregation rules require an FCM to treat and deal with the customer funds of each of its customers as belonging to such customer, separately account for and segregate from its own assets such customer funds, and not use such customer funds to margin the transactions or secure or extend the credit of any customer or person other than the customer for whom such customer funds are held. Additionally, an FCM may deposit segregated funds only with certain types of permitted depositories, which are banks, trust companies, DCOs and other registered FCMs (a "**depository**"), in accounts with account names that clearly identify the funds therein as belonging to the FCM's customers and show the funds are segregated as required by the applicable segregation rules. As used herein, a "**segregated account**" of an FCM means an account maintained by the FCM in accordance with the segregation rules with an individual depository to hold segregated funds in respect of customers of the same account class, and the "**segregated funds account**" of an FCM means all segregated accounts (on a combined basis) maintained by the FCM with all depositories that hold segregated funds in respect of customers of the same account class. An exception to the requirement to segregate customer funds from its own assets arises in relation to the residual interest of the FCM in the statutory trust (see paragraph 1.10 for more detail on the FCM's residual interest).

[11] As noted in footnote 5 above, although the customer is the beneficial owner of the transactions recorded to the omnibus customer positions account under the agent-trust arrangement, this does not mean that the FCM has a duty to account to the customer for trading gains realised in respect of the transactions on a gross basis (or for the entirety of the transactions). This is because, immediately upon any value accruing in respect of those transactions (that is, upon the DCO's determination of the accrued amounts, prior to the DCO and FCM's settlement of the resulting variation margin payments), the accrued amounts become subject to a "statutory trust" pursuant to the segregation rules, as described in paragraph 1.7 and footnote 14, and the terms of the customer agreement. As noted, the "statutory trust" is distinct from the "agent-trust" under which the transactions are held by the FCM. The beneficial entitlement under the agent-trust therefore appears to confer very little value upon the customer, other than to ensure that the beneficial ownership of the transaction does not fall into the estate of the FCM. Put another way, the economic value of the agent-trust to the customer is comprised in the statutory trust because all the proceeds of the agent-trust accrue to the statutory trust. In respect of the amounts comprised in the statutory trust, the FCM's duty to account to the customer is at all times limited to the "net liquidating equity" of the customer's account determined pursuant to the segregation rules and the terms of the customer agreement as described in further detail in footnote 14.

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investments specified by the CFTC and retain as its own any income resulting therefrom (however, the FCM must also segregate such investments and bears sole responsibility for any losses resulting from them). Additionally, the FCM is permitted to commingle customer funds of different customers on an omnibus basis in its segregated funds account and required to commingle certain of its own funds as described in paragraph 1.10.

**1.9** For every customer's funds, there are therefore two relevant accounts: (i) the customer's account carried by the FCM in its books in the name of the customer that, in addition to recording all the customer's transactions, records the state of account as between the FCM and the customer relating to the customer's funds and (ii) the FCM's segregated funds account (which may comprise multiple segregated accounts maintained by the FCM with one or more depositories (which includes a segregated account at each DCO) to hold segregated funds). A customer of an FCM does not have an interest in any particular asset held in segregation, but rather has a beneficial interest in the total assets held in segregation. The customer's beneficial interest in the assets held in segregation is determined by reference to the net liquidating equity of the customer's account on the books and records of the FCM, as described in the definition of "net liquidating equity" in footnote 14[12].

**1.10** The FCM is also required by CFTC regulations to maintain[13] its own funds in its segregated accounts as a cushion of proprietary funds in order to protect against becoming undersegregated by failing to hold a sufficient amount of funds in such accounts to meet the CFTC's segregation requirement[14]. At any given point in time, the statutory trust over the

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[12] As a consequence, it cannot be said that any particular assets comprising the segregated funds belong to any particular customer. Rather, each customer (and the FCM to the extent of its residual interest, which is a remainder entitlement subordinate to the aggregate of the customers' beneficial interests) has a beneficial (or equitable) interest in all the assets comprising the segregated funds. The extent of each customer's beneficial interest is to a monetary value of the segregated funds equal to its net liquidating equity (see footnote 14 below) and the FCM's beneficial interest is in the remainder of the value of the segregated funds. This beneficial interest is a proprietary interest in the segregated funds but not in individual segregated funds.

[13] The requirement to maintain funds may mean the FCM is required to deposit its own funds in the segregated funds account to protect against becoming undersegregated.

[14] The segregation requirement. The segregation rules require that an FCM maintain in segregation funds in an amount at least sufficient in the aggregate to cover the FCM's "total obligations" to all customers of the relevant account class and define the FCM's total obligations to customers as the aggregate amount of funds equal to the positive "net liquidating equity" for every customer in the account class, as reflected in the customer's account as described below (the "**segregation requirement**"). Under the segregation requirement, the FCM must maintain in segregation an amount equal to the sum of all positive net liquidating equities of its customer accounts, and this amount may not be reduced by any negative net liquidating equities of its customer accounts. As the FCM must be in compliance with the segregation requirement at all times (otherwise, the FCM would be using funds of one customer to margin positions of another customer or to cover losses of another customer), the FCM maintains its own funds as a residual beneficial interest in its segregated funds account in order to provide a buffer or cushion of funds to protect against the FCM from becoming undersegregated by failing at any time to maintain sufficient funds in segregation to satisfy the segregation requirement. In practice, the FCM establishes a target residual interest that is in an amount that, when maintained as its residual interest in its segregated accounts, reasonably ensures that the FCM remains in compliance with the segregation requirement at all times. The FCM's residual interest constitutes the portion of funds in excess of that necessary for compliance with the segregation requirement (i.e. the aggregate of the positive net liquidating equities of all customers having positive net liquidating equities, with no reduction for customer net liquidating equities that are negative). The FCM may make withdrawals from segregated funds that are not made to or for the benefit of customers (ie the FCM may make withdrawals for its own proprietary uses) to the extent of its actual residual interest, subject to certain limitations and conditions as described in footnote 20.

The undermargined amounts requirement. Additionally, for each customer account whose net liquidating equity is insufficient to cover the margin required for the customer's open positions, the FCM is required to compute, based on information available to it as of the close of each business day, an undermargined amount and to have, prior to specific points in time on the following business day (at the point of daily settlement with the relevant DCOs in the case of cleared swaps and 6:00 pm Eastern Time in the case of futures), residual interest in its segregated funds account in an amount at least equal to the sum of the undermargined amounts in its customer accounts. This requirement provides a mechanism by which an FCM demonstrates its compliance with the prohibition on its use of one customer's funds to margin or settle positions of another customer.

segregated funds is held by the FCM as a trustee for the benefit of all its customers of the same CFTC account class (to the extent of the aggregate customer funds, which we understand, is broadly equal to the aggregate of the positive net liquidating equities of customers in the account class) and for its own benefit (to the extent the segregated funds

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Net liquidating equity. Under the segregation rules an FCM must reflect in a customer's account the "**net liquidating equity**" for such customer, calculated as the market value of any customer funds that the FCM receives from the customer, as adjusted by (i) any permitted uses (as defined in paragraph 1.14 of this overview and summary), (ii) any accruals on permitted investments (as referenced in paragraph 1.8 of this overview and summary) of such collateral that, pursuant to the FCM's customer account agreement with the customer are creditable to the customer; (ii) any gains and losses with respect to the customer's transactions, (iv) any charges lawfully accruing to the customer, including any commission, brokerage fee, interest, tax or storage fee and (v) any appropriately authorised distribution or transfer of such collateral.

In practice, the net liquidating equity reflected in a customer's account is determined in accordance with customer margining standards established by a representative committee of SROs, including the National Futures Association and U.S. futures exchanges, that participate in a joint audit and financial surveillance program with respect to FCMs that has been approved and is overseen by the CFTC. Such standards, which address, among other things, when an FCM must call for margin, how excess margin is calculated and when it may be disbursed to customers and how to compute net liquidating equity for margining purposes, represent applicable law to which the customer's account and transactions are subject, and operate together with the provisions of customer agreements relating to customer margin, payment, reimbursement and indemnification obligations to establish the customer's contractual rights to amounts payable to it under its customer agreement.

Under the margining standards, net liquidating equity of a customer's account -- which is referred to in the standards as "**margin equity**" rather than as net liquidating equity -- is computed by an FCM that utilises the "total equity" method for determining margin deficiencies as equal to the sum of:

(1) the account's open trade equity balance ("**OTE**"), which represents the net cumulative unrealised gains and losses in respect of the customer's open positions (i.e. the OTE of an open position as of any date reflects the net cumulative gain or loss in respect of the position (for the period from the establishment of the position to such date), which is "realised" by the customer only upon the closing of the position, when the net cumulative gain or loss in respect of the position either increases or decreases the cash balance of the customer's account and thereafter is no longer reflected in the account's OTE balance);

(2) the account's cash balance, which (A) is increased by (i) cash deposited as margin with the FCM, (ii) the net cumulative gains realised in respect of the customer's positions when they are closed (which equals the positions' net positive OTE immediately prior to their closure) and (iii) any other amounts payable to the customer under the customer agreement and (B) is decreased by (i) the net cumulative losses realised in respect of the customer's positions when they are closed (which equals the positions' net negative OTE immediately prior to their closure), (ii) any permitted withdrawals of excess cash margin from the account by the customer and (iii) commissions, brokerage fees, taxes, interest and other charges to the account; and

(3) the non-cash margin balance of the account, which equals (A) the collateral value (which is subject to haircut) of securities or other non-cash margin deposited with the FCM less (B) any permitted withdrawals of excess non-cash margin from the account by the customer.

Although daily trading gains and losses in respect of open positions are settled by exchanges of variation margin between the FCM and DCO and increase or decrease the account's OTE balance, they do not increase or decrease the account's cash balance until the positions are closed and the net gains or losses are realised. Nonetheless, trading gains and losses do increase or decrease the account's margin equity (or in other words, the net liquidating equity) and determine whether an account is undermargined and a margin call must be made or whether there is excess margin that the customer may request be disbursed to it or that will support new trading activity.

As a general matter, when a customer's account is undermargined, an FCM issues a margin call to the customer, and the amount of the call is the difference between the margin equity (or net liquidating equity) and the initial margin requirement for the account. To the extent the account's margin equity (or net liquidating equity) exceeds the initial margin requirement for the account, such excess margin amount constitutes "**free funds**" available for withdrawal by the customer from the account without restriction. When free funds are disbursed to the customer, the amount of the disbursement is debited from the cash balance (if cash is disbursed) or the non-cash margin balance (if non-cash margin is returned) of the customer account.

Under such an account arrangement, the customer does not have a claim against the FCM for payment of trading gains in respect of transactions on a gross basis. Prior to liquidation of the customer's positions, it only has a right to payment of free funds in the account representing the excess of margin equity (net liquidating equity) over the initial margin requirement, and following liquidation of all its positions (and non-cash margin), it has either a right to payment from the FCM of the account's positive cash balance (i.e. its "**credit balance**") or an obligation to pay the FCM the account's negative cash balance (i.e. its "**debit balance**"). A right to gross trading gains would presuppose the existence of trading gains and losses as distinct claims that could be set off against one another when in fact they are represented as individual credits and debits to an account in respect of which only a cash balance is ultimately payable.

in the segregated funds account exceed the aggregate customer funds of all customers whose customer funds are held in the segregated funds account, such excess referred to in this overview and summary as the FCM's "**residual interest**")[15]. The customer funds and the FCM's residual interest together constitute the entirety of the entitlement to the segregated funds, with the extent of the residual interest being defined by exhaustion as the remainder of the segregated funds after accounting for the aggregate customer funds.

**1.11** On a day-to-day basis, an FCM is required to deposit any funds received from a customer to margin its transactions and any funds received from a DCO in respect of the customer's transactions in the FCM's segregated funds account. Additionally, when funds received from DCOs in respect of variation margin on a customer's transactions are deposited in the FCM's segregated funds account maintained with the FCM's depositories, the FCM credits the open trade equity balance of the customer account of the relevant customer at the FCM by the relevant amount accruing to such customer and when funds are withdrawn from the FCM's segregated funds account by a DCO in respect of variation margin on a customer's transactions, the FCM debits the open trade equity balance of the relevant customer's account with the FCM by the relevant amount[1617].[18]

**1.12** In the event of the FCM's insolvency, under the U.S. Bankruptcy Code and pursuant to the CFTC's Part 190 rules (which were promulgated pursuant to authority granted it by the provisions of the Bankruptcy Code applicable to commodity broker liquidations), "customer property", which includes, amongst other things, customer funds, open customer contracts and the FCM's residual interest, are not part of the general bankruptcy estate of an FCM. Customer property forms a separate estate that must be distributed to customers on the

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[15] As noted in footnote 14, the aggregate amount of funds the FCM must maintain in segregation equals the aggregate of the positive net liquidating equities of all customers having positive net liquidating equities, with no reduction for customer net liquidating equities that are negative.

[16] Variation margin owed to or by the DCO is paid out of or into the segregated funds accounts. However, there is no 1:1 correspondence between the variation margin amounts paid to or from the DCO in respect of transactions recorded to the omnibus customer positions account and the amounts credited to or debited from the customer's account balance, as the amounts owed *vis-a-vis* the DCO are calculated on a net basis in respect of all positions of all customers in such omnibus customer positions account (i.e. net across different customers of the same FCM) whereas the FCM's obligations *vis-a-vis* each of its customers arise on an individual customer basis.

[17] In practice, the OTE balance of the customer account may be calculated on the basis of variation margin accrued and may therefore be adjusted prior to the actual settlement of the funds in respect of variation margin, which may occur on the following trading day.

[18] Initial margin. When a customer's position in a contract is established with a DCO, the FCM will use segregated funds to satisfy the DCO's initial margin requirement for the position and the FCM will call for initial margin from the customer (to the extent that the margin equity (net liquidating equity) of the customer's account is less than the account's initial margin requirement after it is increased by the amount of the initial margin the FCM requires for the position from the customer, which may be more than the initial margin for the position the FCM is required to deposit with the DCO). If the customer meets the FCM's margin call by depositing cash with the FCM, the FCM will deposit the cash in its segregated funds account (which will increase the FCM's segregated funds), and the FCM will credit the full amount of the customer's deposit to the cash balance of the customer's account (which will increase the liability of the FCM to the customer and the customer's net liquidating equity claim to the FCM's segregated funds). When the position is closed or settled, the aggregate amount of initial margin the FCM is required to maintain with the relevant DCO will be reduced by the amount of initial margin the FCM was required by the DCO to maintain in respect of the position, and the aggregate initial margin requirement applicable to the customer's account will be reduced by the amount of initial margin the customer was required by the FCM to maintain in respect of the position.

Variation margin. At the end of each trading day, the DCO will mark to market the position and determine a variation margin amount payable by the DCO to the FCM (or by the FCM to the DCO) equal to any trading gain (or loss) in respect of the position for that trading day. The variation margin accrual in respect of the position for each trading day during which the position remains open will increase (or decrease) each of (i) the balance of the FCM's segregated funds account and (ii) the position's open trade equity reflected in the customer's account, but such accrued amount will not increase (or decrease) the customer account's cash balance. When the position is closed, the FCM will credit (or debit) the cash balance of the customer's account by the amount of the position's open trade equity, which will represent the net cumulative (i.e. life-to-date) gain or loss in respect of the position (and thereafter no open trade equity will be reflected in respect of the l closed position).

basis and to the extent of such customers' "allowed net equity claims"[19]. The customer transactions do not appear on the balance sheet of an FCM as its assets. However, because FCMs traditionally retained the right to receive and retain any income earned on the segregated funds, FCMs have previously been required to include the customer funds consisting of cash on their balance sheets. More recently, some FCMs have disclaimed that right and have taken other measures to permit them to exclude the customer funds consisting of cash from their balance sheets as well. Even prior to the U.S. Bankruptcy Code being revised to provide explicitly that customer funds are not available to creditors of the FCM, courts had awarded customers a preference to funds held in segregation, although there was a lack of certainty (owing to inconsistent reasoning in judicial decisions and the practice of FCMs comingling customer funds with their own assets) as to the basis on which they did so.

*Account structures, FCM's duties to customers and reimbursement rights*

**1.13** The terms of a customer agreement permit (and in some circumstances may require) the FCM to deal with the transactions in accordance with the arrangements agreed (or implied) between the FCM and its customer and entitle the FCM to reimburse itself out of the customer's funds for costs and expenses properly incurred in the FCM's performance of its obligations and exercise of its rights under the customer agreement.

**1.14** The terms of the statutory trust over the segregated funds permit the FCM to deal with the trust property in accordance with the segregation rules and as provided (or implied) in the customer agreement and entitle the FCM to reimburse itself out of the trust property (the segregated funds) for costs and expenses properly incurred in the FCM's performance of its obligations and exercise of its rights under the customer agreement (in each case, subject to certain statutory limitations). In particular, the FCM is permitted to withdraw from segregation and apply segregated funds as necessary in the normal course of business to margin, guarantee, secure, transfer, adjust or settle a customer's transactions with a DCO or another FCM, including to pay commissions, brokerage, interest, taxes, storage and other

[19] By way of high level (and approximate) summary, the Part 190 rules provide that the "allowed net equity" claim of a customer is equal to the aggregate of the "funded balances" of such customer's "net equity" claim for each account class (plus or minus certain adjustments specified in the Part 190 rules).

A customer's "net equity" is defined as "the total claim of a customer against the estate of the FCM based on the contracts held by the FCM for or on behalf of such customer less any indebtedness of the customer to the FCM" and, as a general matter, tracks the customer's "net liquidating equity" for purposes of the segregation rule and its "margin equity" for purposes of margining, commencing with a determination of the "equity balance" of the customer account by computing the sum of the cash balance (reflecting cash deposited, realised gains and realised losses, disbursements to or on behalf of the customer and the normal costs attributable to the payment of commissions, brokerage, interest, taxes, storage, transaction fees, insurance and other costs and charges lawfully incurred in connection with the purchase, sale, exercise or liquidation of any contract in the account"), the open trade equity balance and the current realisable market value of any securities or other property held by or for the FCM from or for such account, plus accrued interest.

As a general matter, a customer's "funded balance" is defined to mean a customer's pro rata share of the "customer estate" with respect to each account class available for distribution to customers of the same account class and is computed for each account class by multiplying (A) a fraction equal to (i) the amount of the net equity claim of such customer for such account class divided by (ii) the sum of the net equity claims of all customers for such account class by (B) the property of the FCM's estate that must be allocated for pro rata distribution among customers of that account class (and which so allocated will constitute a separate estate of the customer class and account class) and includes segregated funds.

charges incurred in connection with the customer's transactions ("**permitted uses**")[20]. Other costs and expenses that are chargeable to the customer but not necessary to the execution of transactions and maintenance of the transactions may be charged to the customer's account maintained with the FCM (by debiting the account's cash balance), but may not be paid directly from segregated funds. However, by charging the customer's account for these costs through a debit to the account's cash balance, the FCM is effectively offsetting a liability of the customer to the FCM (in respect of the customer's reimbursement obligation) against the FCM's liability to the customer in respect of the account's cash balance that causes a reduction of the cash balance and thus the customer's net liquidating equity and a corresponding reduction in the customer's interest in the funds held in segregation (and the FCM's residual interest in the segregated funds increases by a corresponding amount)[21]. This permits the FCM to withdraw from the segregated account funds corresponding to the liability provided that the FCM satisfies the conditions and restrictions for withdrawal of residual interest funds.

**1.15** A simplified summary of account structures at both the DCO and FCM level is set out at Figure 1 below.

[20] An FCM may also make withdrawals from segregated funds that are not made to or for the benefit of customers (including for its own proprietary uses) to the extent of its actual residual interest, subject to certain limitations and conditions. Among other things, withdrawals of residual interest funds not made to or for the benefit of customers must not (i) occur prior to the completion of a daily segregation calculation for the prior day (adjusted to account for activity that may have decreased residual interest since the prior day's close of business), (ii) exceed 25 per cent of the prior day's residual interest without certain senior management approvals and regulatory notices or (iii) result in the funds of one customer being used to margin or carry the transactions, or extend the credit, of any other customer or person. Additionally, if such a withdrawal causes the FCM to not hold sufficient funds in its segregated accounts to meet its targeted residual interest, it must deposit its own funds to restore the account balance to the targeted amount by the end of the next business day (or revise the targeted amount), and if the FCM discovers at any time that it holds insufficient funds in segregated accounts to meet its obligations with respect to the segregation requirement or its undermargined amounts requirement, it must immediately deposit sufficient funds into segregation to bring the account into compliance.

[21] Introducing broker fees are an example of such costs. Fees payable to introducing brokers are typically chargeable to a customer's account but represent general obligations of an FCM to the broker (which are reimbursable by the customer) and may not be paid to the broker directly out of segregated funds. Instead, the FCM must use its own funds to pay the broker and obtain reimbursement from the customer. The FCM may do so by debiting the cash balance of the customer's account, which will reduce the customer's net liquidating equity claim to, and thereby increase the FCM's residual interest in, the FCM's segregated funds. In practice, an FCM may utilize this method in connection with payment of the FCM's commissions and fees payable by the customer to the FCM, as well as reimbursement of amounts paid by the FCM to third parties in respect of the customer's transactions (such as amounts the FCM may be required to pay to counterparties to offsetting transactions the FCM must enter into to liquidate cleared swaps of a defaulting customer).

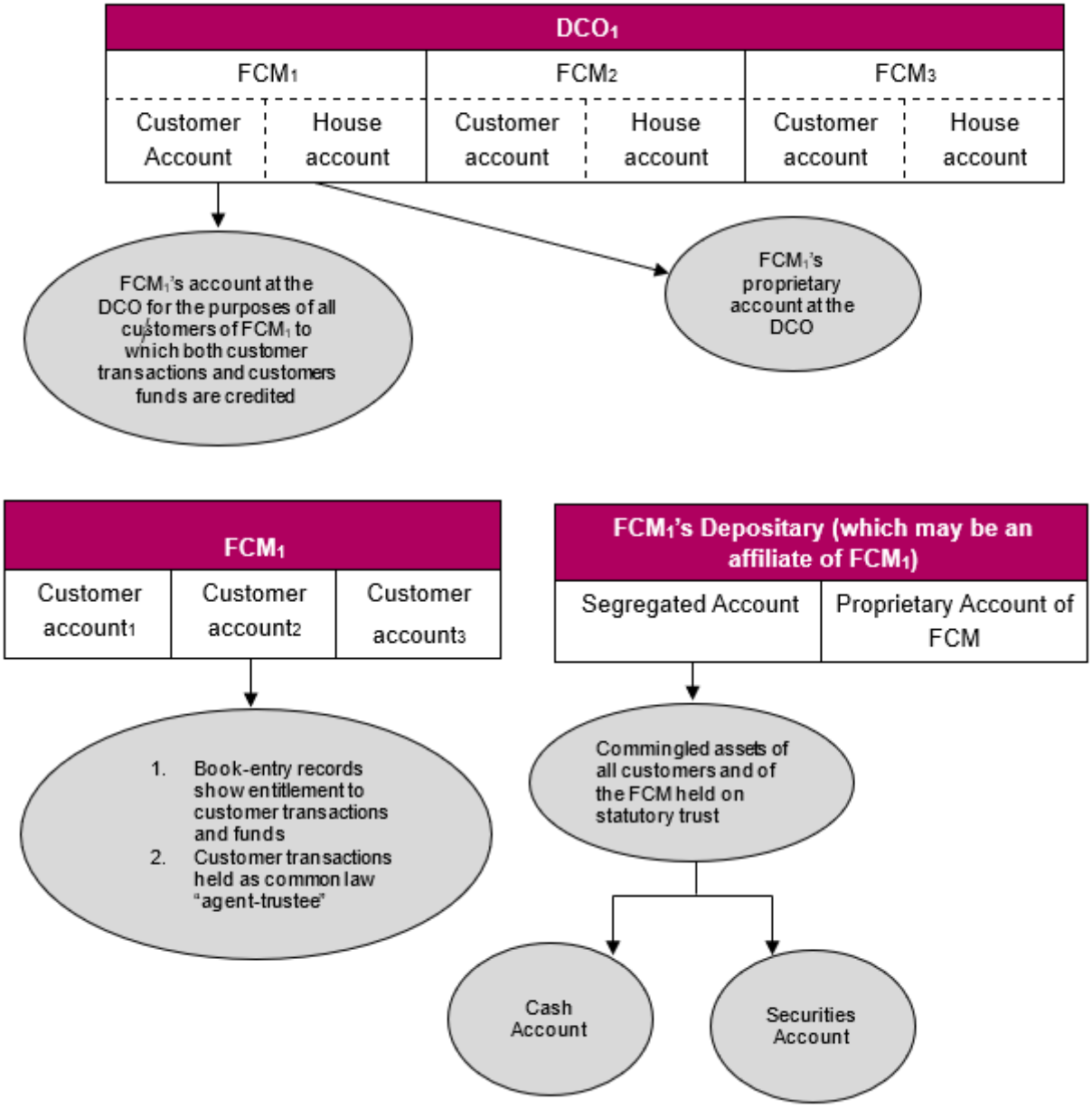


*Figure 1: a simplified summary of account structures at DCO and FCM level*

**1.16** As part of the arrangement between the FCM and the customer, the FCM also has a number of duties to the customer with respect to transactions and the customer account maintained with the FCM. Such duties include accounting to the customer (as the beneficial owner) for all profits and losses arising out of transactions cleared on the customer's behalf as described earlier and, so long as the customer is not in default under the customer agreement and except as otherwise provided by the terms of the customer agreement, following the customer's instructions as to the management of the transactions and the customer account.

*Security over the transactions and customer funds*

**1.17** In addition and separate to the statutory trust, under the terms of the customer agreement, the customer grants to the FCM a security interest over (i) the customer funds and (ii) the transactions. As a matter of strict legal interpretation, as the customer is not the owner in law of the segregated account or the transactions, this will amount to security over the customer's rights in respect of the customer funds and the transactions, which, given that such customer funds and transactions are held on trust for the customer, will be security over the customer's beneficial interest under the specific statutory trust in respect of the customer funds and the beneficial interest in the agent-trust over the transactions as opposed to creating security over the assets themselves. The security interest secures all liabilities of the customer to the FCM under the customer agreement. It may also secure liabilities of the customer to the FCM other than under the customer agreement. This security interest serves the additional purpose in the U.S. of preventing third parties from gaining an intervening interest, or otherwise interfering, in the transactions.

## 2 Legal relationships between DCO, FCM and customer – post-customer default and the liquidation process

**2.1** As noted in Section 1 above, the FCM holds the transactions as agent-trustee under the direction of the customer acting as principal, subject to and in accordance with the customer agreement. When a customer defaults (including upon an insolvency), the FCM is freed of the obligation to follow the customer's instructions[22] and is permitted to act in its own interest. In essence, the FCM is no longer bound to act as agent of the customer, although it continues to hold the transactions on trust for the customer under the agent-trust and the customer funds on trust for the customer under the statutory trust. The FCM may liquidate the customer's transactions and any related collateral, as described below. Although the FCM's right to take these actions arises out of the same contract (the customer agreement) that establishes the agency relationship, the FCM does not take these actions as the customer's agent. Rather, the FCM exercises the contractual rights given to it in the customer agreement to protect itself from the liabilities and losses that it would otherwise suffer as a result of having entered into the transactions and acted as the customer's agent. In doing so the FCM is entitled to prefer its own interest to that of its customer without seeking customer consent with respect to the self-protective steps it takes. These contractual termination rights effectively operate to constrain the extent of the agency relationship (which otherwise requires the FCM as agent to act on the instructions of its principal, the customer).

**2.2** As the FCM holds the transactions for the benefit of the customer, the FCM must account to the customer (as the beneficial owner) for all profits and losses arising out of transactions cleared on the customer's behalf as described earlier.[23] As described in paragraphs 1.6., 1.13 and 1.14 of this overview and summary, it is also entitled to reimburse itself for any losses incurred or indemnification rights to which it is entitled out of the segregated funds pursuant to the terms of the customer agreement and the statutory trust.

[22] It should be noted that the obligation to follow the customer's instructions is not unconditional. It is common for customer agreements to provide that the FCM may decline to accept customer orders in certain circumstances, e.g., when doing so would result in a breach of a trading or position limit. An FCM may also be entitled to liquidate customer contracts in some non-default scenarios.

[23] However, as described in footnote 11, the FCM is not required, under the terms of the customer agreement, to account to the customer for the entire value of the transactions held on the agent-trust.

**2.3** We now set out our understanding of the specific liquidation rights available to the FCM (as mentioned in paragraph 2.1 above) under a Futures and Options Agreement and a Cleared Derivatives Addendum.

*Liquidation under a Futures and Options Agreement*

**2.4** The Futures and Options Agreement contains one or more events of default (whether or not described therein as "events of default") the effect of which is to give the FCM the right to exercise certain remedies in respect of the futures transactions and customer funds credited to the customer account at the FCM. Among such events of default are defaults predicated on (a) the customer's filing under applicable bankruptcy or similar insolvency laws, (b) the filing of a petition for the commencement of involuntary proceedings in respect of the customer under applicable bankruptcy or similar insolvency laws which filing results in a judgment of insolvency or bankruptcy or an order for relief and (c) the appointment in respect of the customer or substantially all of its assets of an administrator, conservator, receiver or similar official (a "**Futures Event of Default**").

**2.5** Following a Futures Event of Default (and in certain circumstances, even where there is no Futures Event of Default), the FCM is entitled to exercise its contractual rights to liquidate the futures transactions (such liquidation will, in practice, be carried out following similar mechanisms to those under the Cleared Derivatives Addendum, as described and discussed further below) and cause the futures transactions to be debited from the customer account at the FCM (the "**Futures Liquidation**"). In carrying out the Futures Liquidation the FCM is also permitted to enter into transactions, either credited to the customer account at the FCM and the omnibus customer positions account at the DCO or not, for the purposes of hedging the risk of the futures transactions (or portions thereof) in a manner similar to Risk-reducing Transactions (in respect of which, see below) and Mitigation Transactions (in respect of which, see below).

**2.6** In effecting a Futures Liquidation, an FCM can be viewed as acting in reliance on its contractual entitlement under the Futures and Options Agreement and the relevant DCO rules, which does not need to involve the enforcement of any security interests[24]. In doing so, the FCM acts as principal pursuant to the exercise of its contractual rights under the Futures and Options Agreement (and in accordance with the terms of the applicable DCO rules), and not as agent.

**2.7** Following the Futures Liquidation, the net cumulative gains or losses in respect of the customer's futures transactions are realised and the open trade equity in respect of the transactions will increase or decrease the cash balance of the customer's account[25]. The FCM may also liquidate any non-cash margin credited to the applicable segregated funds account (and debit it from the non-cash margin balance of the related customer's account) and credit the amount of the resulting liquidation proceeds to the applicable segregated funds account (and credit it to the cash balance of the related customer's account, leading to an adjustment in the net liquidating equity of the customer reflecting any difference in the value recorded for such non-cash margin and the proceeds received). The FCM will then determine an aggregate net amount payable in connection with the liquidation or deemed liquidation (to the extent permitted under the terms of the Futures and Options Agreement)

[24] In other words, the FCM, as the DCO's contractual counterparty under (and holder of legal title to) the customer's transactions, would exercise rights granted to it by the DCO to cause the closure of, and thereby terminate the customer's beneficial interest in, the transactions.

[25] See footnote 18.

of the futures transactions, being the final net liquidating equity of the customer's account. Such net amount represents the final cash balance of the customer account following the debit of all costs and the credit of all proceeds associated with the Futures Liquidation. If such amount is a credit balance (and, therefore, represents a liability of the FCM), the FCM will have a duty to account for such amount to the customer or if such amount is a debit balance (and, therefore, represents a liability of the customer), the customer will have a duty to account for such amount to the FCM[26].

*Liquidation under a Cleared Derivatives Addendum*

**2.8** Following an event of default[27] under the Cleared Derivatives Addendum (a "**Cleared Derivatives Event of Default**") (and in certain circumstances, even where there has been no event of default), the FCM (or, in the case of certain valuations, its affiliate) is entitled to designate a liquidation date and thereupon cause the liquidation of the customer's cleared derivatives transactions by way of any of the following methods:

**2.8.1** entering into "**Offsetting Transactions**", i.e. entering into transactions which are credited to the omnibus customer positions account at the DCO and the customer account at the FCM the effect of which is to offset all or part of one or more transactions which results in a full or proportional reduction from the omnibus customer positions account at the DCO and the customer account at the FCM of the affected transactions. Due to operational limitations on the ability of an FCM to cause Offsetting Transactions it has traded to be directly credited to an omnibus customer positions account, the FCM would either (i) trade Offsetting Transactions for its house account and cause them to be transferred to its omnibus customer positions account to offset the customer transactions or (ii) cause the customer transactions in the omnibus customer positions account to be transferred to its house account, where they would be offset by Offsetting Transactions traded for its house account. Following the determination of the associated costs (or gains) resulting from the entry into of the Offsetting Transactions and the realisation of cumulative gains and losses in respect of the transactions, the FCM will debit or credit the cash balance of the customer account by the net open trade equity of the transactions, determine the customer's net liquidating equity and, if such amount is a credit balance, the FCM will have a duty to account for such amount to the customer or if such amount is a debit balance, the customer will have a duty to account for such amount to the FCM;

**2.8.2** entering into "**Sale/Novation Transactions**", i.e. selling, assigning or novating one or more transactions to another entity whereby the obligations of the customer are substituted, in whole or in part, with the obligations of the assignee (and the old obligations are extinguished). The effect of this is to cause transactions to be debited from the omnibus customer positions account at the DCO and the customer account at the FCM against receipt or payment of cash. Following the determination of the associated costs (or gains) resulting from the entry into of the Sale/Novation

[26] More specifically, when futures position are liquidated, the net cumulative gains or losses in respect of the positions (represented by their OTE) are realised and will increase or decrease the cash balance of the customer's account. The cash balance will also be increased by the amount of any proceeds from the FCM's liquidation of non-cash margin credited to the customer's account (leading to an adjustment in the net liquidating equity of the customer reflecting any difference in the value recorded for such non-cash margin and the proceeds received). The FCM will also debit and credit the cash balance for other amounts due to the FCM or to the customer under the customer agreement. The final cash balance of the customer's account will equal the customer's net liquidating equity in respect of the account. A positive balance will constitute a credit balance due to the customer and a negative balance will be a debit balance due to the FCM.

[27] Such events will likely be similar to those under the Futures and Options Agreement, as detailed above.

Transactions, if such amount is a credit balance, the FCM will have a duty to account for such amount to the customer or if such amount is a debit balance, the customer will have a duty to account for such amount to the FCM;

**2.8.3** entering into "**Replacement Transactions**", i.e. terminating the affected transactions credited to the omnibus customer positions account at the DCO and the customer account at the FCM and entering into new transactions credited to the FCM's house account at the DCO on materially identical terms. Once such Replacement Transactions are established they are promptly liquidated by the FCM offsetting them against one or more Mitigation Transactions ("**Replacement Offsetting Transactions**"). Following the determination of the associated costs (or gains) resulting from the entry into of the Replacement Transactions and the Replacement Offsetting Transactions, the FCM will debit or credit the cash balance of the customer account by the net open trade equity of the transactions, determine the customer's net liquidating equity and, if such amount is a credit balance, the FCM will have a duty to account for such amount to the customer or if such amount is a debit balance, the customer will have a duty to account for such amount to the FCM;[28]; or

**2.8.4** valuing all or part of one or more transactions by determining any losses, costs or gains with respect thereto. At the point of valuation, the transactions cease to be trust property and instead are replaced by a duty to account for their value. Equally, at such point, the transactions cease to be the customers' transactions and become FCM proprietary transactions (i.e. for the purposes of the client, they are liquidated). They then need to be removed from the customer account at the FCM and the omnibus customer positions account at the DCO.

**2.9** In addition, the FCM (or, in the case of Mitigation Transactions, its affiliate) may enter into one or more transactions credited to the customer account at the FCM and the omnibus customer positions account at the DCO in order to hedge the risk of the transactions (or portions thereof) on an individual or portfolio basis ("**Risk-reducing Transactions**") or enter into similar transactions that are not credited to the customer account at the FCM or the omnibus customer positions account at the DCO, but instead credited to the FCM's house account ("**Mitigation Transactions**"). Following the determination of the associated costs (or gains) resulting from the entry into of the Risk-reducing Transactions and Mitigation Transactions, either the FCM will have a duty to account for such amount to the customer or the customer will have a duty to account for such amount to the FCM (together with paragraphs 2.8.1 to 2.8.3 above, the "**Cleared Derivatives Liquidation**").

**2.10** In effecting a Cleared Derivatives Liquidation, an FCM can be viewed as acting in reliance on its contractual entitlement under the Cleared Derivatives Addendum and the relevant DCO rules, which does not need to involve the enforcement of any security interests[29]. In doing so, the FCM acts as principal pursuant to the exercise of its contractual rights under the Cleared Derivatives Addendum (and in accordance with the terms of the applicable DCO rules), and not as agent.

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[28] The method of liquidation by way of "Replacement Transactions" was introduced in the FIA/ISDA 2018 version of the Cleared Derivatives Addendum and will therefore only be relevant where the parties have entered into the 2018 version of the Cleared Derivatives Addendum.

[29] In other words, as in the case of a Futures Liquidation, the FCM, as the DCO's contractual counterparty under (and holder of legal title to) the customer's transactions, would exercise rights granted to it by the DCO to cause the closure of, and thereby terminate the customer's beneficial interest in, the transactions.

**2.11** Following the Cleared Derivatives Liquidation, the FCM will determine an aggregate net amount payable in connection with such Cleared Derivatives Liquidation (the "**Cleared Derivatives Liquidation Amount**"). Such Cleared Derivatives Liquidation Amount represents the final cash balance of the customer account following the debit of all costs and the credit of all proceeds associated with the Cleared Derivatives Liquidation and may reflect any or all of the following: (i) trading gains and losses incurred by the FCM (or, in the case of Mitigation Transactions, the FCM or its affiliates) in entering into or closing out cleared derivatives transactions, Risk-reducing Transactions, Replacement Transactions and Mitigation Transactions, as well as any upfront payments made or received in connection therewith; (ii) valuations associated with cleared derivatives transactions, Risk-reducing Transactions, Replacement Transactions and Mitigation Transactions not closed out through entry into Offsetting Transactions or Replacement Offsetting Transactions (as applicable); (iii) amounts due on account of cleared derivatives transactions, Risk-reducing Transactions, Replacement Transactions and Mitigation Transactions prior to the date on which such transactions are liquidated and (iv) any costs and expenses (including costs of funding), incurred in connection with the exercise of remedies under the Cleared Derivatives Addendum. If the Cleared Derivatives Liquidation Amount is positive, the FCM will have a duty to account for such amount to the customer or if such amount is negative, the customer will have a duty to account for such amount to the FCM.

*Determination and settlement of net amount owing between FCM and customer where there is no enforcement of security*

**2.12** Any gains or proceeds from the Futures Liquidation or Cleared Derivatives Liquidation are required to be credited to the customer account (thereby increasing the amount of assets required to be segregated under the segregation rules) and any losses or amounts due in connection with the Futures Liquidation or Cleared Derivatives Liquidation will lead to a reduction of the customer's net liquidating equity (and corresponding increase in the FCM's residual interest), entitling the FCM to withdraw funds from the segregated funds account. Following the liquidation of all transactions pursuant to the relevant methods set out in paragraphs 2.5, 2.8 and 2.9 above (as applicable), a single net amount is determined by the FCM, being the final net liquidating equity of the customer's account. Such amount forms part of the customer's statutory trust entitlement and reflects the net result of the liquidation of all transactions cleared through all the DCOs through which those transactions were cleared, subject to the deduction of any additional costs and expenses incurred in connection with the liquidation of the customer's transactions and any other losses and expenses incurred in the course of acting as the customer's FCM, in each case that are permitted to be charged to the customer not otherwise reflected in the liquidation valuation processes discussed above.

**2.13** The determination of a customer's net liquidating equity in its account is a form of determination of account by the FCM of the overall position between the FCM and the customer under the statutory trust in accordance with the customer agreement. This represents a determination of the overall value of the single course of dealing between the FCM and the customer rather than the exercise of close-out netting or set off in respect of a number of different transactions. There is no close-out netting or set-off because, as between the FCM and the customer, there are no distinct transactions or obligations that are separate from the overall contractual and trust relationship giving rise to a duty to account either way between the customer and the FCM that is evidenced by the customer agreement.

**2.14** The statutory trust created in respect of the segregated funds (and subject, to the extent permitted by law, to the terms of the customer agreement) expressly permits the FCM to withdraw and apply the segregated funds for the purposes established by the statute (which include those described under paragraphs 2.6, 2.7, 2.10 and 2.11 above). In doing so, the FCM is not foreclosing on or enforcing security over property of the customer or, indeed, exercising any form of legal set-off, but rather the FCM is applying the segregated funds that it holds in the statutory trust created for this purpose in accordance with the terms of the statutory trust to produce a net amount.

**2.15** Consistent with the terms of the statutory trust, the FCM is required to account to the customer for the outstanding balance of the customer account and remains entitled to the residual interest, which it may withdraw for its own account provided that this does not cause the FCM's residual interest to fall below its targeted level.

**2.16** As noted above at paragraph 1.17, pursuant to the terms of the customer agreement, the customer also grants a security interest over the customer's beneficial interest in respect of the customer funds and the transactions. Accordingly, there are two possible routes by which the FCM can seek to rely on the remedies provided for in the customer agreement: (i) the operation of the statutory trust in accordance with its terms (as set out in paragraphs 2.12 to 2.15 above), which does not involve the enforcement of security or (ii) the enforcement of security over the customer's interest under the statutory trust, which is discussed in further detail below. The rights giving rise to these remedies are cumulative and an FCM is entitled to choose either.

*Determination and settlement of net amount owing between FCM and customer by way of enforcement of security*

**2.17** Following an event of default relating to the customer, the FCM is entitled to enforce the security interest over the customer's beneficial interest under the statutory trust and to thereby realise the value of the customer funds held in the segregated funds account.[30] In doing so, the FCM is exercising its rights of disposition of collateral provided for under the Uniform Commercial Code ("**UCC**"). In practice, this will involve very similar steps to those discussed in paragraphs 2.12 to 2.15 above and in exercising any Futures Liquidation or Cleared Derivatives Liquidation the FCM will act as principal in its own name.

**2.18** Any proceeds from the Futures Liquidation or Cleared Derivatives Liquidation become customer funds to be credited to the customer account. Upon an enforcement of the security interest over the customer funds, the customer funds may be realised and the proceeds applied in order to satisfy any amounts owed by the customer to the FCM under the customer agreement, which will include amounts due from the FCM to others in connection with the Futures Liquidation or Cleared Derivatives Liquidation by reason of the FCM's right of reimbursement and indemnification in the customer agreement. Given that the customer's account balance reflects the net amount due to the customer after all liabilities of the customer under the customer agreement have been accounted for, there seems little reason to enforce the security interest over the customer's beneficial interest under the statutory trust as opposed to following the process described in paragraphs 2.12 to 2.15 above, unless this would be required for some specific reason relating to applicable insolvency laws of a customer outside the US.

[30] There is, however, no need to enforce security over the transactions because the FCM is entitled to liquidate them acting as a principal to the transactions. Upon their liquidation, the proceeds become subject to the statutory trust, as described in footnote 11.

**2.19** Once all amounts due to the FCM under or in connection with the customer agreement and the enforcement of the security have been paid to the FCM, the FCM, as secured party, is liable to account for any net balance to the customer. The determination of such net balance due to the customer is a form of determination of account by the FCM of the overall position between the FCM and the customer as a result of the enforcement of the security over the transactions and the customer funds in accordance with the security created under the customer agreement. This represents a determination of the overall value of the overall account between the FCM and the customer rather than the exercise of close-out netting or set off in respect of a number of different transactions. There is no close-out netting or set-off because, as between the FCM and the customer, there are no distinct transactions or obligations that are separate from the overall contractual and trust relationship over which the security has been enforced.

## Annex 2

## Instructions

RECOGNITION OF THE U.S. LAW TRUSTS UNDER WHICH CUSTOMER ASSETS ARE HELD AND ENFORCEABILITY OF THE LIQUIDATION AND CREDIT SUPPORT PROVISIONS OF CERTAIN FUTURES ACCOUNT AGREEMENTS AND A CLEARED DERIVATIVES ADDENDUM UPON A CUSTOMER'S DEFAULT OR INSOLVENCY

Dear Sir or Madam:

On behalf of the International Swaps and Derivatives Association, Inc. ("**ISDA**") and the Futures Industry Association ("**FIA**"), I write this letter to request your advice on certain issues with respect to the operation of the U.S. law trusts under which customer assets are held by a futures commission merchant ("**FCM**") and the enforceability of the liquidation and credit support provisions of certain futures account agreements and a Cleared Derivatives Addendum upon a customer's default or insolvency.

To help you understand the FCM model and applicable U.S. laws, we have provided a memorandum from Sullivan & Cromwell LLP entitled "Analysis of the Relationships Among Customers, FCMs and DCOs Under the U.S. Agency Clearing Model". We have also provided a high-level overview and summary of the main concepts covered, conclusions reached and certain factual assumptions in the Sullivan & Cromwell memorandum, produced by Linklaters LLP.

By way of brief background, certain U.S. statutory and regulatory provisions, as well as the nature of the arrangements between the DCO, FCM and customer dictate that customer assets and transactions are held by the FCM on trust (there are technically two distinct trusts) for the benefit of the customer. The customer assets and transactions do not form part of the bankruptcy estate of an FCM. Following a customer default, a single amount, which represents the determination of account as between the FCM and customer, is either owed to the FCM from the customer or from the FCM to the customer under the terms of the trusts and the contractual arrangements between the FCM and the customer. The customer also grants a security interest over the customer's beneficial interest under the trusts for the benefit of the FCM.

We would like you to provide a legal opinion to address:

(a) whether your jurisdiction would recognize and uphold the "agent-trust" under which the customer transactions are held by the FCM for the benefit of the customer and the statutory trust under which the customer funds and securities are held by the FCM for the benefit of the customer as well as the operation of the close-out procedures under such trusts, as set out in further detail below;

(b) the enforceability of the liquidation and credit support provisions of certain Covered Base Agreements (as defined below) entered into by an entity that is registered with the United States Commodity Futures Trading Commission (the "**CFTC**") as a FCM and is a member of one or more CFTC-registered derivatives clearing organizations and such FCM's customer, setting forth the right of such FCM, upon the occurrence of an event giving rise to any right of such FCM to liquidate all Futures Transactions (as defined below), to liquidate such transactions, determine amounts owing with respect thereto, exercise remedies in respect of Futures Payment Rights (as defined below) and the proceeds thereof with respect to obligations arising from Futures Transactions and apply Futures Credit Support (as defined below) transferred by that customer in connection therewith in order to determine an aggregate net balance of account as between the FCM and the customer; and

(c) the enforceability of the liquidation and credit support provisions of an addendum for Cleared Derivatives Transactions in the form published by FIA and ISDA in 2012 or 2018 (each a "**CDA**"), each of which have been provided to you, entered into by a FCM and such FCM's customer, setting forth the right of such FCM, upon the occurrence of an event giving rise to any right of such FCM to liquidate all Cleared Derivatives Transactions (as defined below) under the CDA, to liquidate such transactions, determine amounts owing with respect thereto, exercise remedies in respect of Cleared Derivatives Payment Rights (as defined below) and the proceeds thereof with respect to obligations arising from Cleared Derivatives Transactions and apply Cleared Derivatives Credit Support (as defined below) transferred by that customer in connection therewith in order to determine an aggregate net balance of account as between the FCM and the customer.

*Recognition of U.S. Law Trusts and Enforceability of Liquidation and Credit Support Provisions*

The recognition and upholding of the U.S. law trusts under which customer assets are held by an FCM and the enforceability of the liquidation and credit support provisions is of importance to FCMs that have entered into Futures Transactions and Cleared Derivatives Transactions governed by a Covered Base Agreement and CDA as a matter of both credit risk assessment and considerations of capital adequacy.

Accordingly, ISDA and FIA would like to ask your firm to prepare the opinion for England and Wales ("**your jurisdiction**"). In connection with the preparation of the new opinion, we enclose for your information two forms of the FIA-ISDA Cleared Derivatives Addendum published by the FIA and ISDA, one published in 2012 and one published in 2018, and a redline comparing the two. Your opinion should be based on the assumptions describing a CDA below rather than this published form of CDA, but we believe based on the advice of US counsel that both of these published forms meet those assumptions. Please note that there is not an industry-standard published form of Covered Base Agreement.

*Assumptions for Covered Base Agreement and CDA*

(a) Covered Base Agreements

(i) Pursuant to a futures customer account agreement (a "**Covered Base Agreement**") entered into between a FCM and a customer, the FCM agrees to carry one or more accounts on behalf of that customer (each, an "**Account**") and to execute, carry and clear transactions for the purchase or sale of commodities for future delivery on, or subject to the rules of, a derivatives clearing organization (a "**DCO**") registered as such under the United States Commodity Exchange Act (the "**CEA**") or traded on, or subject to the rules of, a board of trade outside the United States (such contracts executed on a contract market designated pursuant to Section 5 of the CEA and cleared by a U.S.-registered DCO, "**U.S. Futures**", such contracts traded on or subject to the rules of, a board of trade outside the United States, and options thereon, "**Foreign Futures**" and, collectively "**Futures**") and/or options on U.S. Futures subject to Part 33 of the rules of the CFTC (such contracts, "**Options**", and collectively with Futures, "**Futures Transactions**"). With respect to Foreign Futures, the FCM acts for the customer by carrying Foreign Futures on the customer's behalf with, and guaranteeing the customer's performance to, clearing members ("**Foreign FCMs**") of the relevant foreign clearinghouses, which Foreign FCMs may frequently be affiliates of the FCM, and the Foreign FCMs will, in turn, enter into back-to-back futures transactions cleared by foreign clearinghouses.

(ii) Each Covered Base Agreement is governed by New York law.

(iii) Pursuant to a Covered Base Agreement, the customer agrees to transfer, as applicable, initial margin and variation margin payments as the FCM may require in respect of the customer's

Futures Transactions. Also, pursuant to the Covered Base Agreement, the customer grants a security interest to the FCM in all of the customer's rights in the following property, whether at the time of the grant or thereafter existing, and the proceeds of those rights:

(A) "**Futures Credit Support**", including:

(1) with respect to U.S. Futures and Options, its Account and all assets credited thereto, including assets held by a DCO, as well as other property of the customer held in respect of Futures Transactions by or for the FCM, the DCO or any agent acting for the FCM, the DCO or the customer;

(2) with respect to Foreign Futures, its Account and all assets credited thereto, including assets held by a Foreign FCM or foreign clearinghouse, as well as other property of the customer held in respect of Futures Transactions by or for, or for the Account and due from, the FCM, any Foreign FCM, any foreign clearinghouse or others, or any agent acting for the FCM, any Foreign FCM, any foreign clearinghouse or others; and

(B) "**Futures Payment Rights**", including:

(1) with respect to U.S. Futures and Options, its Futures Transactions and all rights to payment thereunder (whether constituting obligations of the FCM or a DCO);

(2) with respect to Foreign Futures, its Futures Transactions and all rights to payment thereunder (whether constituting obligations of the FCM, a Foreign FCM or a foreign clearinghouse).

The security interest secures all obligations of the customer to the FCM under the Covered Base Agreement.

As a matter of strict legal interpretation, given that the assets credited to the customer Account and the Futures Transactions are held on trust for the customer, the security interest which the customer grants to the FCM will be a security interest over the customer's beneficial interest under the specific statutory trust in respect of the assets listed in limb (A) above and the beneficial interest under the "agent-trust" in respect of the Futures Transactions as opposed to creating security over the assets and Futures Transactions themselves.

(iv) A Covered Base Agreement contains one or more events of default (whether or not described therein as "events of default") (each, an "**Event of Default**") the effect of which is to give the FCM the right to liquidate (and thereby terminate) the Futures Transactions held in the customer's Account ("**Futures Liquidation Rights**"). Among such Events of Default are defaults predicated on (A) a customer's filing under applicable bankruptcy or similar insolvency laws, (B) the filing of a petition for the commencement of involuntary proceedings in respect of the customer under applicable bankruptcy or similar insolvency laws which filing results in a judgment of insolvency or bankruptcy or an order for relief and (C) the appointment in respect of the customer or substantially all of its assets of an administrator, conservator, receiver or similar official, including the possession and control of the property of the customer by such an official pursuant to seizure orders.

(v) A Covered Base Agreement includes a provision the effect of which is to permit the FCM, upon the occurrence of an Event of Default in respect of a customer, to liquidate and/or carry out a valuation of all Futures Payment Rights and Futures Credit Support, as set out in paragraphs 2.5 to 2.7 of the Linklaters summary. The FCM is entitled to reimburse itself out of the Futures Payment Rights or the Futures Credit Support (or the liquidation value thereof) for any liabilities, costs and expenses properly incurred in the performance of its agency.

(vi) Pursuant to the terms of a Covered Base Agreement, following the exercise of its rights in limb (v) above, the FCM determines an aggregate net amount payable in connection with the liquidation or deemed liquidation (if applicable) of the Futures Transactions. This represents a determination of the overall value of the single course of dealing between the FCM and the customer rather than the exercise of close-out netting or set off in respect of a number of different transactions (the "**Futures Determination of Account**"). If such amount is positive (and, therefore, represents a surplus for the FCM), the FCM will have a duty to account for such amount to the customer or if such amount is negative (and, therefore, represents a deficit for the FCM), the customer will have a duty to account for such amount to the FCM.

A futures account agreement that does not alone satisfy the above requirements is nevertheless a "Covered Base Agreement" to the extent it is paired with a CDA that supplies any of the otherwise unsatisfied requirements.

(b) The CDA

(i) In addition to entering into a Covered Base Agreement with the customer, the FCM and the customer execute the CDA. The CDA supplements a Covered Base Agreement with respect to, among other things, the liquidation and Determination of Account (as defined below) relating to "Cleared Derivatives Transactions" carried in the customer's account holding Cleared Derivatives Transactions (the "**Cleared Derivatives Account**"), as well as the application of collateral related to those Cleared Derivatives Transactions. "**Cleared Derivatives Transactions**" are swaps, forwards, options, or similar transactions (but excluding Futures Transactions executed on or subject to the rules of a U.S. designated contract market or on a foreign board of trade and subject to regulation in that jurisdiction) that are (a) entered into by a customer in the over-the-counter market, or (b) executed or traded by such customer on or subject to the rules or protocols of any multilateral or other trading facility, system or platform, including any communication network or auction facility permitted under applicable law or any designated contract market and, in either case, subsequently submitted to and accepted for clearing by a DCO and subject to the CFTC's Part 22 rules. To the extent that a security-based swap is, in accordance with applicable law, carried by an FCM in a cleared swaps customer account (as defined in the CFTC's Part 22 rules), such security-based swap constitutes a Cleared Derivatives Transaction.

(ii) Each CDA is governed by New York law.

(iii) Pursuant to the CDA, Cleared Derivatives Transactions become incorporated into the related Covered Base Agreement, which incorporation is accomplished by considering references to "Contracts," "Futures," "Futures Contracts" and similar terms in such Covered Base Agreement to include references to the Cleared Derivatives Transactions. Through this incorporation, the customer grants a security interest to the FCM in all of the customer's rights in the following property, whether at the time of the grant or thereafter existing, and the proceeds of those rights:

(A) (1) its Cleared Derivatives Account and all assets credited thereto, including assets held by a DCO, and (2) other property of the customer held in respect of Cleared Derivatives Transactions by or for the FCM, the DCO and any agent acting for the FCM, the DCO or the customer (collectively, "**Cleared Derivatives Credit Support**"); and

(B) its Cleared Derivatives Transactions and all rights to payment thereunder (whether constituting obligations of the FCM or a DCO) and the customer's rights, if any, in all cash received by the FCM and all rights to payment in favor of the FCM or the customer arising out of or in connection with the exercise by the FCM of any right to terminate, liquidate or otherwise close out the customer's account or Cleared Derivatives Transactions (collectively, "**Cleared Derivatives Payment Rights**").

As a matter of strict legal interpretation, given that the assets listed in limb (A) above and the Cleared Derivatives Transactions are held on trust for the customer, the security will be over the customer's beneficial interest under the specific statutory trust in respect of the assets listed in limb (A) above and the beneficial interest under the "agent-trust" in respect of the Cleared Derivatives Transactions as opposed to creating security over the assets and Cleared Derivatives Transactions themselves.

(iv) The FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a customer's Cleared Derivatives Transactions by way of a number of different methods and processes, as set out in paragraphs 2.8 and 2.9 of the Linklaters summary (such rights, the "**Cleared Derivatives Liquidation Rights**" and, together with the Futures Liquidation Rights, the "**Liquidation Rights**"). The FCM is also entitled to dispose of or realize on (i) all Cleared Derivatives Credit Support posted by the customer to the FCM in respect of Cleared Derivatives Transactions and (ii) any margin transferred to the customer under Cleared Derivatives Transactions. The FCM can reimburse itself out of such assets and the Cleared Derivatives Payment Rights (or the liquidation value thereof) for any liabilities, costs and expenses properly incurred in the performance of its agency.

(v) Pursuant to the terms of the CDA, following the exercise of its rights in limb (iv) above, the FCM determines an aggregate net amount payable in connection with the liquidation or deemed liquidation (if applicable) of the Cleared Derivatives Transactions. This represents a determination of the overall value of the single course of dealing between the FCM and the customer rather than the exercise of close-out netting or set off in respect of a number of different transactions (together with the Futures Determination of Account, the "**Determination of Account**"). If such amount is positive (and, therefore, represents a surplus for the FCM), the FCM will have a duty to account for such amount to the customer or if such amount is negative (and, therefore, represents a deficit for the FCM), the customer will have a duty to account for such amount to the FCM.

*Liquidation Rights*

There are two distinct routes by which an FCM can choose to exercise its Liquidation Rights: (i) by reliance on its contractual and trust entitlement under the Covered Base Agreement and/or the CDA (which does not need to involve the enforcement of any security interests) (the "**Trust Liquidation Rights**") or (ii) by way of enforcement of its security over the customer's interest in the "agent-trust" and statutory trust (the

"**Enforcement Liquidation Rights**"). Whichever route is preferred by the FCM, the exercise of the Liquidation Rights is carried out by the FCM as principal and not as agent pursuant to the exercise of its contractual and/or security rights under the Covered Base Agreement and/or the CDA (and in accordance with the terms of the applicable DCO rules).

A summary of the operation and legal basis by which an FCM exercises its Trust Liquidation Rights is set out in further detail in the Linklaters summary and, in particular, under paragraphs 2.12 to 2.15 thereof.

A summary of the operation and legal basis by which an FCM exercises its Enforcement Liquidation Rights is set out in further detail in the Linklaters summary and, in particular, under paragraphs 2.17 to 2.19 thereof.

*Scope of opinion*

Our members have found that it is important (for example, for ensuring the enforceability of the Determination of Account for regulatory capital purposes) that the scope of the opinion be clear and certain, both in terms of the types of transactions covered by the opinion and the types of customers falling within the scope of the opinion.

*Scope of Transaction types covered by the opinion*

As explained above, the types of transaction that may be entered into under a Covered Base Agreement and CDA include both Futures Transactions and Cleared Derivatives Transactions (together, "**Covered Transactions**"). We do not describe herein the scope of transactions that may be Futures Transactions (other than the requirements of the definition of Futures Transaction set out above). Appendix A dated September 2012 contains a brief description of various types of Cleared Derivatives Transactions that might be documented under a Covered Base Agreement and CDA (although some of those Cleared Derivatives Transactions may not currently be cleared by any DCO and should be attached as Appendix A to your opinion and modified as necessary to indicate clearly in your opinion whether your conclusions in your opinion for any reason do not apply to any of these types of Covered Transactions).

*Scope of Customers covered by the opinion*

Please indicate the scope of customers covered by your opinion in an Appendix B to your opinion, which references the types of counterparty described in Appendix B dated September 2009. Your opinion should, at a minimum, cover customers falling within the categories "Bank/Credit Institution", "Corporation" and "Investment Firm/Broker Dealer".

Appendix B sets out a series of commercial descriptions. We understand that these may not correspond precisely to legal categories under the laws of your jurisdiction. Please indicate, therefore, for each Appendix B category covered by your opinion, the precise legal form for each counterparty type falling within that category that is covered by your opinion. Please include, if relevant, any naming convention or rule that would help a reader of the opinion to identify and classify the entity (for example, the inclusion of a designation in the legal name of the entity such as "S.A.", "N.V.", "A.G.", "S.p.A", "Plc", "Limited" or the like or the mandatory inclusion of a word or words in the name, for example, "Bank" in relation to banks or "Insurance" or "Assurance" in relation to insurance companies).

In relation to each Appendix B category covered by your opinion, if your opinion does not cover all relevant legal forms of counterparty that are capable of falling within that category in your jurisdiction, please indicate clearly what is excluded. For example, if your opinion covers corporations that fall within the

category "Investment Firm/Broker Dealer" but not partnerships that fall within that category, then please indicate that fact.

If you are aware of any potential legal issues with respect to the recognition of the U.S. trusts, the operation of the Determination of Account or the enforceability of the Liquidation Rights with regard to any types of entity that are not covered in your opinion, our members have indicated that it would nevertheless be helpful if you could highlight such potential legal issue such that further analysis can be undertaken separately if desired.

Finally, your opinion may cover one or more category types that do not fall within any of the categories in Appendix B or are otherwise difficult to classify. As above, please indicate the precise legal form and any relevant naming conventions or mandatory naming rules for each additional category covered by your opinion.

An example of an entity difficult to classify would be a German Förderbank (development bank), which is owned by the Sovereign (the Federal Republic of Germany) or by a State of a Federal Sovereign (that is, a Bundesland, such as Nordrhein-Westfalen). Therefore, it would be a Sovereign-Owned Entity. It would also be a Bank/Credit Institution if its core business involves taking deposits and making loans. An entity type that is difficult to classify should be dealt with in your opinion as an additional category.

It is most helpful if all information relating to customer scope is presented in Appendix B to your opinion in table form and the body of the opinion refers to Appendix B without a separate discussion of customer scope. If you feel it is necessary to include a discussion of customer scope within the text of the opinion, please carefully reconcile it with the information presented in Appendix B so that the customer scope of the opinion is clear.

Additional customer types covered by your opinion and for which there is no category set out in the standard Appendix B should be added in additional rows to Appendix B.

*Fact Patterns*

We set out below three principal fact patterns we would like you to consider in answering the questions below.

The three principal fact patterns concern (a) whether or not the Location (as defined below) of the customer is in your jurisdiction and (b) whether or not the Location of the Collateral (as defined below) is in your jurisdiction.

In particular, when responding to each question, could you please distinguish between the following three fact patterns:

I. The Location of the customer is in your jurisdiction and the Location of the Collateral is outside your jurisdiction.

II. The Location of the customer is in your jurisdiction and the Location of the Collateral is in your jurisdiction.

III. The Location of the customer is outside your jurisdiction and the Location of the Collateral is in your jurisdiction.

For the foregoing purposes:

(a) the "Location" of the customer is in your jurisdiction if it resides, is incorporated or otherwise organized in your jurisdiction and/or if it has a branch or other place of business in your jurisdiction; and

(b) the "Location" of Collateral is the place where an asset of that type is located under the private international law rules of your jurisdiction.

"Located" when used below in relation to a customer or any Collateral should be construed accordingly.

In relation to (a), if under the laws of your jurisdiction, the Location of an entity would be determined on a different basis and this would affect your conclusions, please set out the relevant rules and explain their consequences.

In considering fact patterns I and II, please indicate whether and, if so, in which circumstances it makes a difference whether (i) the counterparty is incorporated or otherwise organized in your jurisdiction or (ii) it is a foreign entity with a branch or other place of business in your jurisdiction.

If the location of the FCM would affect your response to any question, please make this clear in the relevant response.

*I.* *Recognition and Operation of the U.S. Trusts and Exercise of the Trust Liquidation Rights*

A. Assumptions

1. On the basis of the terms and conditions of a Covered Base Agreement and CDA and other relevant factors and acting in a manner consistent with the intentions stated in the Covered Base Agreement and CDA, the parties over time enter into a number of Covered Transactions that are intended to be governed by the Covered Base Agreement and CDA. The Covered Transactions entered into include any or all of the transactions described in Appendix A.

2. Some of the Covered Transactions provide for an exchange of cash by both parties and others provide for the physical delivery of shares, bonds or commodities in exchange for cash.

3. After entering into these Covered Transactions and prior to the maturity thereof, the customer, which is organized in your jurisdiction, becomes the subject of a voluntary or involuntary case under the insolvency laws of your jurisdiction and, subsequent to the commencement of the insolvency, either the customer or an insolvency official seeks to challenge the operation of the Determination of Account (by, for example, assuming the profitable Covered Transactions for the customer and rejecting the unprofitable Covered Transactions for the customer) or otherwise prevent the operation of the "agent-trust" or the statutory trust or the exercise of the Liquidation Rights.

B. Issues

1. Would the parties' agreement on governing law of each Covered Base Agreement and CDA and submission to jurisdiction be upheld in your jurisdiction, and what would be the consequences if they were not?

2. Would each of the methods by which an FCM can bring about the liquidation of a customer's Futures Transactions and Cleared Derivatives Transactions (i.e. the Cleared Derivatives Liquidation Rights), as set out in paragraphs 2.8 and 2.9 of the Linklaters summary, be recognized and upheld under your jurisdiction. If a particular method would either not be upheld or may be challenged, please provide further detail and explain the reason for this.

3. Would the "agent-trust" and statutory trust be recognized and upheld under the laws of your jurisdiction as creating a valid trust over the relevant customer transactions and assets whereby the FCM holds the legal title to the relevant customer transactions and assets and the customer holds a beneficial interest in the trust as a whole (as opposed to maintaining an interest in any specific assets under the trust).

4. Would the exercise by the FCM of its Trust Liquidation Rights (including the operation of the Determination of Account), upon the occurrence of an Event of Default in respect of a customer, be recognized and upheld under the laws of your jurisdiction.

5. Is there any risk that either the "agent-trust" or the statutory trust would be recharacterised under your jurisdiction (e.g. as security)? If so, how would the exercise by the FCM of its Trust Liquidation Rights be characterised under the laws of your jurisdiction.

6. Under your jurisdiction, are any rights or processes available to a creditor of a customer by which such creditor could make a claim against the customer assets held on the statutory trust or against the Futures Transactions and Cleared Derivatives Transactions (and any rights in respect thereof) held on the "agent-trust" by the FCM for the benefit of the customer as opposed to only having recourse to the single net amount that constitutes the Determination of Account?

7. Assuming the parties have entered into a Covered Base Agreement and CDA, the customer is insolvent and the FCM has determined a lump-sum termination amount in a currency other than the currency of the jurisdiction in which the insolvent customer is organized:

(1) would a court in your jurisdiction enforce a claim for the net termination amount in the currency in which it was determined?

(2) can a claim for the net termination amount be proved in insolvency proceedings in your jurisdiction without conversion into the local currency?

If in either case the claim must be converted to local currency for purposes of enforcement or proof in insolvency proceedings, please set out the rules governing the timing and exchange rate for such conversion.

8. Are there any other local law considerations that you would recommend the FCM to consider in connection with the exercise of the Trust Liquidation Rights (including the operation of the Determination of Account)?

9. Are there any other circumstances you can foresee that might affect the FCM's ability to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction?

10. Assuming that the FCM's ability to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction will be recognized in your jurisdiction, will such rights be capable of exercise without recourse to or enforcement of the Trust Security Interest or any Collateral Security Interest described below?

*II.* *Enforceability of the Security Interest and Exercise of the Enforcement Liquidation Rights*

A. Assumptions

Please assume the same facts as set forth in Part I above (as applicable) with the following modifications:

(a) Pursuant to the relevant Covered Base Agreement and CDA, the FCM and the customer agree that Futures Credit Support and Cleared Derivatives Credit Support ("**Collateral**") will include cash credited to an account (as opposed to physical notes and coins) and certain types of securities (as further described below) that are Located or deemed Located either (i) in your jurisdiction, or (ii) outside your jurisdiction.

(b) Please assume that any securities provided as Collateral are denominated in either the currency of your jurisdiction or any freely convertible currency and consist of (i) corporate debt securities whether or not the issuer is organized or located in your jurisdiction; (ii) debt securities issued by the government of your jurisdiction; and (iii) debt securities issued by the government of a member of the "G-10" group of countries, in one of the following forms:

(i) directly held bearer debt securities: by this we mean debt securities issued in certificated form, in bearer form (meaning that ownership is transferable by delivery of possession of the certificate) and, when held by a FCM or a DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or a DCO (that is, not held by the FCM or DCO indirectly with an Intermediary (as defined below));

(ii) directly held registered debt securities: by this we mean debt securities issued in registered form and, when held by a FCM or DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or DCO so that the FCM or DCO is shown as the relevant holder in the register for such securities (that is, not held by the FCM or DCO indirectly with an Intermediary);

(iii) directly held dematerialized debt securities: by this we mean debt securities issued in dematerialized form and, when held by a FCM or DCO as Collateral under a Covered Base Agreement and CDA, held directly in this form by the FCM or DCO so that the FCM or DCO is shown as the relevant holder in the electronic register for such securities (that is, not held by the FCM or DCO indirectly with an Intermediary);

(iv) intermediated debt securities: by this we mean a form of interest in debt securities recorded in fungible book entry form in an account maintained by a financial intermediary (which could be a central securities depositary ("CSD") or a custodian, nominee or other form of financial intermediary, in each case an "Intermediary") in the name of the FCM or DCO where such interest has been credited to the account of the FCM or DCO in connection with a transfer of Collateral by the customer to the FCM under a Covered Base Agreement and CDA.

The precise nature of the rights of the FCM in relation to its interest in intermediated debt securities and as against its Intermediary will be determined, among other things, by the law of the agreement between the FCM and its Intermediary relating to its account with the Intermediary, as well as the law generally applicable to the Intermediary, and possibly by other considerations arising under the general law or the rules of private international law of your jurisdiction. The FCM's Intermediary may itself hold its interest in the relevant debt securities indirectly with another Intermediary or directly in one of the three forms mentioned in (i), (ii) and (iii). In practice, there is likely to be a number of tiers of Intermediaries between the FCM and the issuer of such securities, at least one of which will be an Intermediary that is a national or international CSD.

Our expectation is that the FCM will normally hold debt securities in the form of intermediated debt securities rather than directly in one of the three forms mentioned in (i), (ii) and (iii).

(c) Due to regulatory requirements, posted Collateral will be held by intermediaries in a way that identifies the Collateral as belonging to customers of the FCM. For example, if the Collateral is held by the FCM or an intermediary of the FCM, that account will show that it is held for customers generally and the FCM's books will show that such Collateral is held for the individual customer. If posted Collateral is held by the DCO or an intermediary of the DCO, that account will show that it is held for customers generally and, if such Collateral constitutes Cleared Derivatives Credit Support, the DCO's books will show that the Collateral is held for the individual customer.

(d) Please assume that cash Collateral is denominated in a freely convertible currency and is held in an account under the control of the FCM or DCO.

(e) U.S. regulatory requirements impose a duty to segregate customer funds and thereby establish a specific statutory trust over Collateral (including cash Collateral) held by the FCM for the benefit of all its customers (together with the Futures Payment Rights and the Cleared Derivatives Payment Rights, the "**Trust Assets**"). Because it is not possible to trace any particular funds in the commingled segregated account to any particular customer, a customer of an FCM does not have an interest in any particular asset held in segregation, but rather has a fractional interest in the total assets held in segregation.

(f) As the FCM is the sole counterparty to the contract made on the customer's behalf with a DCO, it holds legal title to the Futures Transactions and Cleared Derivatives Transactions credited to such customer's account on behalf of the customer. The FCM holds these transactions on an "agent-trust" for the benefit of each customer. Each customer will, accordingly, have a beneficial interest in the "agent-trust" over the Futures Transactions and Cleared Derivatives Transactions credited to its specific customer account. Each "agent-trust" held by the FCM for a customer will be distinct from all other "agent-trusts" held by the FCM for the benefit of its other customers.

(g) The terms of the statutory trust over the segregated funds and each "agent-trust" permit the FCM to deal with the trust property in accordance with relevant legislation and as provided (or implied) in the customer agreement and entitle the FCM to reimburse itself out of the property for costs and expenses properly incurred in the performance of its agency (in each case, subject to certain statutory limitations). In particular, the FCM is permitted to use the customer funds credited to a customer's account to margin, guarantee, secure, transfer, adjust or settle the customer's transactions, including to pay commissions, brokerage, interest, taxes, storage and other charges relating to the customer's transactions.

(h) A customer's beneficial interest in the statutory trust (which is common to all customers) and its beneficial interest in the "agent-trust" (which is specific to such customer) is not an interest in any specific asset that constitutes the statutory trust or the "agent-trust" but rather is a beneficial interest in the relevant trust property as a whole (the "**Trust Beneficial Interest**").

(i) The customer also grants a security interest over its Trust Beneficial Interest to the FCM. This amounts to creating security over the customer's beneficial interest under the specific statutory trust in respect of the Collateral in its customer account and the beneficial interest in the "agent-trust" over the Futures Transactions and Cleared Derivatives Transactions (i.e. the Trust Beneficial Interest) (the "**Trust Security Interest**") as opposed to creating security over the Trust Assets themselves.

(j) In the case of questions 8 to 10 and 18 in Part C below, if relevant, please also assume that after entering into the Covered Transactions and prior to the maturity thereof, an Event of Default exists and is continuing with respect to the customer (which is located in your jurisdiction), and/or the FCM has

designated a date to begin exercising its Futures Liquidation Rights or Cleared Derivatives Liquidation Rights (a "**Liquidation Date**") as a result thereof (however, an insolvency proceeding has not been instituted, which is addressed separately in assumption (k) and questions 11 to 13 below).

(k) In the case of questions 11 to 13 in Part C below, if relevant, please assume that a formal bankruptcy, insolvency, liquidation, reorganization, administration or comparable proceeding (collectively, the "**insolvency**") has been instituted by or against the customer (which is located in your jurisdiction) and an Event of Default has accordingly occurred under the Covered Base Agreement and CDA. If there are different types of insolvency proceedings under the laws of your jurisdiction (for example, bankruptcy or liquidation proceedings where an entity does not emerge as a going concern, on the one hand, and a reorganization or administration proceeding where an entity is restructured and does continue as a going concern, on the other hand), please briefly describe the different types of proceedings and answer each question with respect to each such proceeding.

B. Issues – Consequences of Security Interest

*Consequences of creating a security interest in your jurisdiction*

1. Would the security interest granted by the customer to the FCM be recognized under your jurisdiction as creating a security interest over the customer's Trust Beneficial Interest in the form of a Trust Security Interest as set out in assumption A.(i) above or, alternatively, as creating a security interest directly over the Trust Assets themselves in the form of a Collateral Security Interest as described immediately before question 13 below?

2. In respect of the security interest created, as set out in your answer to question 1 above, are there any local law consequences of the creation of such security interest that should be considered and may affect the arrangements between the FCM and its customers? In particular, are there any provisions under local law that may render such security interest void (for example, as a result of non-compliance with registration formalities) and therefore cause the money secured by the security interest to become immediately payable?

**Subject to the paragraph below, the provisions and questions that follow only need to be considered and addressed if your response to question 10 in Section I.B above was to confirm that the FCM's ability to exercise the Trust Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction will be recognized in your jurisdiction, but dependent upon recourse to or enforcement of the Trust Security Interest or any Collateral Security Interest. If there is no dependency upon a security interest, please ignore the remainder of this instruction letter.**

**If your response to question 1 in Section II.B above was to confirm that a security interest would be created directly over the Trust Assets themselves (rather than the Trust Beneficial Interest), please respond to questions 14 to 20 (inclusive) below.**

C. Issues – Trust Security Interest

Please note the following point regarding substitution of collateral. We understand that Covered Base Agreements typically provide that, following termination of a position by a customer, a FCM is under no obligation to return the same assets (e.g. a security with the same ISIN/CUSIP number) posted by the customer, but the FCM will endeavor to provide equivalent assets, if practicable. For example, if the

customer posted 5-year treasuries, the FCM would endeavor to return 5-year treasuries if practicable, but not necessarily the same ISIN/CUSIP. In some cases, the FCM might agree to a more stringent obligation to return equivalent assets, if practicable. However, it is not market practice for a Covered Base Agreement to provide for an unqualified obligation on a FCM to return the same asset (contrast this position with paragraph 4(d) of either the 1994 ISDA Credit Support Annex (Bilateral Form) or the 1995 ISDA Credit Support Deed (Bilateral Form – Security Interest)).

We also understand that, as a matter of market practice, FCMs often offer their customers the ability to manage the collateral posted by the customer, for example by allowing the customer to post 10-year treasuries and returning 5-year treasuries to the customer. However, this is purely a matter of market practice, not a right of the customer explicitly provided in the agreement.

As the Covered Base Agreements typically do not include a right to substitute collateral, this letter does not include a question regarding the effect of substitution rights on the validity, continuity, perfection or priority of the Trust Security Interest and the Collateral Security Interest, each as defined below (in contrast with opinions obtained by ISDA on the two credit support documents referenced above). However, please let us know if you think the market practice described above raises any questions that should be addressed in the opinion.

*Validity of Trust Security Interest*

1. Under the laws of your jurisdiction, what law governs the operation of the Trust Security Interest? Would the courts of your jurisdiction recognize the validity of the Trust Security Interest, assuming it is valid under the governing law of the Covered Base Agreement and CDA?

2. Under the laws of your jurisdiction, what law governs the proprietary aspects of the Trust Security Interest (that is, the formalities required to protect the Trust Security Interest against competing claims) granted by the customer (for example, the law of the jurisdiction of incorporation or organization of the customer, the jurisdiction where the Collateral is Located, or the jurisdiction of location of the FCM or DCO's Intermediary in relation to Collateral in the form of indirectly held securities)? What factors would be relevant to this question? Where the location (or deemed Location) of the Collateral is the determining factor, please briefly describe the principles governing such determination under the law of your jurisdiction with respect to the different types of Collateral. If relevant, please describe how the laws of your jurisdiction apply to each form in which securities Collateral may be held as described in assumption (b) above.

3. Assuming that the courts of your jurisdiction would recognize the Trust Security Interest, is any action (filing, registration, notification, stamping, notarization or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) required in your jurisdiction to perfect the Trust Security Interest? If so, please indicate what actions must be taken and how such actions may differ, if at all, depending upon the type of Collateral which is subject to the Trust Security Interest.

4. If there are any other requirements to ensure the validity or perfection of the Trust Security Interest, please indicate the nature of such requirements. Are there any other documentary formalities that must be observed in order for the Trust Security Interest to be recognized as valid and perfected in your jurisdiction?

5. Assuming that the FCM has obtained a valid and perfected Trust Security Interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions 1 to 4 above, as applicable, will the FCM or the customer need to take any action thereafter to ensure that the Trust Security Interest continues and/or remains perfected, particularly with respect to additional Collateral transferred from time to time when required pursuant to the Covered Base Agreement and CDA?

6. Are there any particular duties, obligations or limitations imposed on the FCM in relation to the care of the Collateral held by it pursuant to the Trust Security Interest?

7. The terms of a Covered Base Agreement and CDA may grant the FCM broad rights with respect to the use of Collateral that constitutes Futures Credit Support and Cleared Derivatives Credit Support and is subject to the Trust Security Interest. Additionally, the Covered Base Agreement and CDA are subject to the rules of DCOs, which may also grant DCOs similar rights with respect to the use of Collateral that has been on-posted from a FCM to a DCO. Such use by the FCM and the DCO might include investing cash posted by the Covered Customer (or on-posted by the FCM to the DCO) in certain types of investments permitted by the CFTC, pledging or rehypothecating the securities pledged by the customer (or repledged by the FCM to the DCO), disposing of the securities under a securities repurchase (repo) agreement or selling securities.

Such rights of use are, though, subject to the CFTC's customer funds segregation rules, which require that customer funds (including any assets resulting from the investment of customer funds and the cash received from rehypothecating or disposing of securities) must be separately accounted for by each of the FCM and DCO, must not be commingled with its own funds, must be held for the benefit of customers and treated as belonging to customers and must be calculated so as to prevent the use of one customer's funds to margin or secure another customer's positions. However, while CFTC rules generally prohibit the commingling of a customer's funds with those of the FCM or any other person, the rules also permit a customer's funds to be commingled with those of other customers of the FCM in segregated customer omnibus accounts and require the FCM to keep its own funds in such segregated omnibus accounts to serve as a cushion in the event of an unexpected shortfall. CFTC rules also permit each of the FCM and a DCO to receive and retain as its own any incremental income or interest income resulting from the investment of customer funds in permitted investments.

Do the laws of your jurisdiction recognize the right of the FCM or DCO so to use such Collateral pursuant to an agreement with the customer? In particular, how does such use of the Collateral affect, if at all, the validity, continuity, perfection or priority of the Trust Security Interest otherwise validly created and perfected prior to such use? Are there any other obligations, duties or limitations imposed on the FCM or DCO with respect to its use of such Collateral under the laws of your jurisdiction? In considering the above question in relation to a DCO, please limit your response to the extent that rights or duties applicable to the DCO under the laws of your jurisdiction are relevant to the validity, continuity, perfection or priority of FCM's Trust Security Interest.

*Exercise of Enforcement Liquidation Rights in the Absence of an Insolvency Proceeding*

Note the additional assumption in II.B.(j) above which applies to questions 8 to 10 below.

8. Assuming that the FCM has obtained a valid and perfected Trust Security Interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions 1 to 4 above, as applicable, what are the formalities (including the necessity to obtain a court order or conduct an auction), notification requirements (to the customer or any other person) or other procedures, if any, that the FCM must observe or undertake in exercising its Enforcement Liquidation Rights (including the operation of the Determination of Account) as an FCM under each Covered Base Agreement and CDA? For example, is it free to sell the Collateral (including to itself) and apply the proceeds to satisfy the customer's outstanding obligations under the Covered Base Agreement and CDA? Do such formalities or procedures differ depending on the type of Collateral involved?

9. Are there any laws or regulations in your jurisdiction that would limit or distinguish a creditor's enforcement rights with respect to the Trust Security Interest depending on (a) the type of transaction underlying the creditor's exposure, (b) the type of Collateral, or (c) the nature of the creditor or the debtor? For example, are there any types of "statutory liens" that would be deemed to take precedence over a Trust Security Interest?

10. How would your response to questions 8 and 9 change, if at all, assuming that an insolvency proceeding described in assumption (j) above has occurred with respect to the FCM (notwithstanding that the Covered Base Agreement and CDA may not provide for any events of default in respect of the FCM) rather than or in addition to the customer (for example, would this affect this ability of the FCM to exercise its Enforcement Liquidation Rights or the operation of the Determination of Account)?

*Exercise of Enforcement Liquidation Rights by the FCM after the Commencement of an Insolvency Proceeding*

Note the additional assumption in II.B.(k) above which applies to questions 11 to 13 below.

11. How are competing priorities between creditors determined in your jurisdiction? What conditions must be satisfied if the FCM's Trust Security Interest is to have priority over all other claims (secured or unsecured) of an interest in the Collateral, other than claims of a DCO?

12. Would the FCM's right to Exercise its Enforcement Liquidation Rights (including the operation of the Determination of Account) be subject to any stay or freeze or otherwise be affected by commencement of the insolvency (that is, how does the institution of an insolvency proceeding change your response to question 8 above, if at all)?

13. Will the customer (or its administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official) be able to recover any transfers of Collateral made to the FCM during a certain "suspect period" preceding the date of the insolvency as a result of such a transfer constituting a "preference" (however called and whether or not fraudulent) in favor of the FCM or on any other basis? If so, how long before the insolvency does this suspect period begin? If such a period exists, would the substitution of Collateral by the customer during this period invalidate an otherwise valid Trust Security Interest if the substitute Collateral constituting Credit Support is of no greater value than the assets it is replacing? Would the posting of additional "variation margin" (an amount that reflects a change in the mark-to-market value of one or more Covered Transactions) during the suspect period be subject to avoidance, either because the Collateral was considered to relate to an antecedent or pre-existing obligation or for some other reason?

*Collateral Security Interest - Assumptions*

Please assume the same facts and assumptions as set forth in Parts I and II above (as applicable) with the following modification:

The security interest granted by the customer to the FCM is over the Trust Assets themselves (i.e. a security interest is created directly over the assets that constitute the Collateral) rather than the Trust Beneficial Interest (the "**Collateral Security Interest**).

14. How would your response to questions 1 to 13 change, if at all, assuming that the security interest created by the customer is a Collateral Security Interest as opposed to a Trust Security Interest? In responding to this question please consider the different Fact Patterns set out above.

15. Would the courts of your jurisdiction recognize the Collateral Security Interest over each type of Collateral as described in assumption (b) above? Please indicate, in relation to cash Collateral, if your answer depends on the location of the account in which the relevant obligations are recorded and/or upon the currency of those obligations.

16. What is the effect, if any, under the laws of your jurisdiction of the fact that the amount secured or the amount of Collateral subject to the Collateral Security Interest will fluctuate under the Covered Base Agreement and CDA (including as a result of entering into additional Covered Transactions from time to time)? In particular:

(a) would the Collateral Security Interest be valid in relation to future obligations of the customer?

(b) would the Collateral Security Interest be valid in relation to future Collateral (that is, Collateral not yet delivered to the FCM at the time of entry into the relevant Covered Base Agreement and CDA)?

(c) is there any difficulty with the concept of creating the Collateral Security Interest over a fluctuating pool of assets, for example, by reason of the impossibility of identifying in the Covered Base Agreement and CDA the specific assets transferred by the customer to the FCM?

(d) is it necessary under the laws of your jurisdiction for the amount secured by the Collateral Security Interest to be a fixed amount or subject to a fixed maximum amount?

(e) is it permissible under the laws of your jurisdiction for the FCM to hold Collateral in excess of its actual exposure to the customer under the related Covered Base Agreement and CDA?

In relation to (a), it is understood that the Collateral Security Interest over any specific Collateral would only be relevant in relation to future obligations, if ever, at the time such future obligations arise and then only in relation to Collateral held at that time. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the Collateral Security Interest as security for such obligations or whether the Security Interest would take effect in relation to those future obligations without further action by either party.

In relation to (b), it is understood that the Collateral Security Interest over the Collateral to be delivered at some point in the future after the time of entry into the relevant Covered Base Agreement and CDA would not take effect in relation to such Collateral until the Collateral had been delivered to the FCM in accordance with the Covered Base Agreement and CDA. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the Collateral Security Interest in relation to such Collateral or whether the Collateral Security Interest would take effect in relation to such Collateral without further action (other than the delivery) by either party.

In relation to (c), you may assume that each specific delivery to the FCM and return by the FCM of Collateral under the Covered Base Agreement and CDA from time to time would be properly recorded by the FCM, so that, while the pool of Collateral would change from time to time, at any specific time the composition of the pool of Collateral could be clearly identified by the FCM.

17. Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the creation and/or perfection of the Collateral Security Interest (for example, because Collateral is located or deemed to be located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected Collateral Security Interest under the laws of such other jurisdiction, will the FCM have a valid Collateral

Security Interest so far as the laws of your jurisdiction are concerned? Is any action (filing, registration, notification, stamping or notarization or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) required under the laws of your jurisdiction to establish, perfect, continue or enforce the Collateral Security Interest? Are there any other requirements of the type referred to in question 4 above (in relation to a Collateral Security Interest rather a Trust Security Interest)?

Note the additional assumption in II.B.(h) above which applies to question 18 below.

18. Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the creation and/or perfection of the Collateral Security Interest (for example, because such Collateral is located or deemed located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected Collateral Security Interest under the laws of such other jurisdiction, are there any formalities, notification requirements or other procedures, if any, that the FCM must observe or undertake in your jurisdiction in exercising its Enforcement Liquidation Rights (including the operation of the Determination of Account)?

*Additional considerations*

19. Are there any other local law considerations that you would recommend the FCM to consider in connection with exercising the Enforcement Liquidation Rights (including the operation of the Determination of Account)?

20. Are there any other circumstances you can foresee that might affect the FCM's ability to exercise the Enforcement Liquidation Rights (including the operation of the Determination of Account) in your jurisdiction.

We would ask that you set forth each question in Sections I.B, II.B and, if relevant, II.C of this letter in italics in your opinion, followed by your response to that question.

Yours faithfully,

[INSERT NAME]

## CERTAIN TRANSACTIONS UNDER

### THE ISDA MASTER AGREEMENTS

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Forward. A transaction in which one party agrees to pay an agreed price for a specified amount of a bond of an issuer or a basket of bonds of several issuers at a future date and the other party agrees to pay a price for the same amount of the same bond to be set on a specified date in the future. The payment calculation is based on the amount of the bond and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the COMEX Division of the New York Mercantile Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a "spot" or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, "Bullion" means gold, silver, platinum or palladium and "Ounce" means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce (or in the case of reference prices not expressed in Ounces, the relevant Units of gold, silver, platinum or palladium).

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security (or in some cases an equivalent security) to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap), rate or index (in the case of an economic statistic cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate, floating index or floating commodity price payer on the cap and the other party is the floating rate, floating index or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price, and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. A Commodity Forward may be settled by the physical delivery of the commodity in exchange for the specified price or may be cash settled based on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index based on the price of one or more commodities.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (e.g., West Texas Intermediate Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Contingent Credit Default Swap. A Credit Default Swap Transaction under which the calculation amounts applicable to one or both parties may vary over time by reference to the mark-to-market value of a hypothetical swap transaction.

Credit Default Swap Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to enter into a Credit Default Swap.

Credit Default Swap. A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity") upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment

default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. A Credit Default Swap may also be physically settled by payment of a specified fixed amount by one party against delivery of specified obligations ("Deliverable Obligations") by the other party. A Credit Default Swap may also refer to a "basket" (typically ten or less) or a "portfolio" (eleven or more) of Reference Entities or may be an index transaction consisting of a series of component Credit Default Swaps.

Credit Derivative Transaction on Asset-Backed Securities. A Credit Default Swap for which the Reference Obligation is a cash or synthetic asset-backed security. Such a transaction may, but need not necessarily, include "pay as you go" settlements, meaning that the credit protection seller makes payments relating to interest shortfalls, principal shortfalls and write-downs arising on the Reference Obligation and the credit protection buyer makes additional fixed payments of reimbursements of such shortfalls or write-downs.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Economic Statistic Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency by reference to interest rates or other factors and the other party pays or may pay an amount or periodic amounts of a currency based on a specified rate or index pertaining to statistical data on economic conditions, which may include economic growth, retail sales, inflation, consumer prices, consumer sentiment, unemployment and housing.

Emissions Allowance Transaction. A transaction in which one party agrees to buy from or sell to the other party a specified quantity of emissions allowances or reductions at a specified price for settlement either on a "spot" basis or on a specified future date. An Emissions Allowance Transaction may also constitute a swap of emissions allowances or reductions or an option whereby one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which the specified quantity of emissions allowances or reductions exceeds or is less than a specified strike. An Emissions Allowance Transaction may be physically settled by delivery of emissions allowances or reductions in exchange for a specified price, differing vintage years or differing emissions products or may be cash settled based on the difference between the market price of emissions allowances or reductions on the settlement date and the specified price.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity and shares to be set on a specified date in the future. The

payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of shares of an issuer or a basket of shares of several issuers at a specified strike price. The share option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed or floating rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor), rate or index level (in the case of an economic statistic floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A deliverable or non-deliverable transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Freight Transaction. A transaction in which one party pays an amount or periodic amounts of a given currency based on a fixed price and the other party pays an amount or periodic amounts of the same currency based on the price of chartering a ship to transport wet or dry freight from one port to another; all calculations are based either on a notional quantity of freight or, in the case of time charter transactions, on a notional number of days.

Fund Option Transaction: A transaction in which one party grants to the other party (for an agreed payment or other consideration) the right, but not the obligation, to receive a payment based on the redemption value of a specified amount of an interest issued to or held by an investor in a fund, pooled investment vehicle or any other interest identified as such in the relevant Confirmation (a "Fund Interest"), whether i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests in relation to a specified strike price. The Fund Option Transactions will generally be cash settled (where settlement occurs based on the excess of such redemption value over such specified strike price (in the case of a call) or the excess of such specified strike price over such redemption value (in the case of a put) as measured on the valuation date or dates relating to the exercise date).

Fund Forward Transaction: A transaction in which one party agrees to pay an agreed price for the redemption value of a specified amount of i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests at a future date and the other party agrees to pay a price for the redemption value of the same amount of the same Fund Interests to be set on a specified date in the future. The payment calculation is based on the amount of the redemption value relating to such Fund Interest and generally cash-settled (where settlement occurs based on the difference between the agreed forward price and the redemption value measured as of the applicable valuation date or dates).

Fund Swap Transaction: A transaction a transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency based on the redemption value of i) a single class of Fund Interest of a Single Reference Fund or ii) a basket of Fund Interests.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Longevity/Mortality Transaction. (a) A transaction employing a derivative instrument, such as a forward, a swap or an option, that is valued according to expected variation in a reference index of observed demographic trends, as exhibited by a specified population, relating to aging, morbidity, and mortality/longevity, or (b) A transaction that references the payment profile underlying a specific portfolio of longevity- or mortality- contingent obligations, e.g. a pool of pension liabilities or life insurance policies (either the actual claims payments or a synthetic basket referencing the profile of claims payments).

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as oil including oil products, coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Property Index Derivative Transaction. A transaction, often structured in the form of a forward, option or total return swap, between two parties in which the underlying value of the transaction is based on a rate or index based on residential or commercial property prices for a specified local, regional or national area.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities (or in some cases equivalent securities) from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

Swap Deliverable Contingent Credit Default Swap. A Contingent Credit Default Swap under which one of the Deliverable Obligations is a claim against the Reference Entity under an ISDA Master Agreement with respect to which an Early Termination Date (as defined therein) has occurred.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.

APPENDIX B
SEPTEMBER 2009

**CERTAIN COUNTERPARTY TYPES**[1]

| **Description** | **Covered by opinion** | **Legal form(s)**[2] |
|---|---|---|
| Bank/Credit Institution. A legal entity, which may be organized as a corporation, partnership or in some other form, that conducts commercial banking activities, that is, whose core business typically involves (a) taking deposits from private individuals and/or corporate entities and (b) making loans to private individual and/or corporate borrowers. This type of entity is sometimes referred to as a "commercial bank" or, if its business also includes investment banking and trading activities, a "universal bank". (If the entity only conducts investment banking and trading activities, then it falls within the "Investment Firm/Broker Dealer" category below.) This type of entity is referred to as a "credit institution" in European Community (**EC**) legislation. This category may include specialised types of bank, such as a mortgage savings bank (provided that the relevant entity accepts deposits and makes loans), or such an entity may be considered in the local jurisdiction to constitute a separate category of legal entity (as in the case of a building society in the United Kingdom (**UK**)). | [Yes][No] | |
| Central Bank. A legal entity that performs the function of a central bank for a Sovereign or for an area of monetary union (as in the case of the European Central Bank in respect of the euro zone). | | |

[1] In these definitions, the term "legal entity" means an entity with legal personality other than a private individual.

[2] If appropriate, please indicate, as discussed in the instruction letter, any naming convention or rule that would help a reader of the opinion to identify and classify the entity.

| **Description** | **Covered by opinion** | **Legal form(s)**[2] |
|---|---|---|
| Corporation. A legal entity that is organized as a corporation or company rather than a partnership, is engaged in industrial and/or commercial activities and does not fall within one of the other categories in this Appendix B. | | |
| Hedge Fund/Proprietary Trader. A legal entity, which may be organized as a corporation, partnership or in some other legal form, the principal business of which is to deal in and/or manage securities and/or other financial instruments and/or otherwise to carry on an investment business predominantly or exclusively as principal for its own account. | | |
| Insurance Company. A legal entity, which may be organised as a corporation, partnership or in some other legal form (for example, a friendly society or industrial & provident society in the UK), that is licensed to carry on insurance business, and is typically subject to a special regulatory regime and a special insolvency regime in order to protect the interests of policyholders. | | |
| International Organization. An organization of Sovereigns established by treaty entered into between the Sovereigns, including the International Bank for Reconstruction and Development (the World Bank), regional development banks and similar organizations established by treaty. | | |

| **Description** | **Covered by opinion** | **Legal form(s)**[2] |
|---|---|---|
| Investment Firm/Broker Dealer. A legal entity, which may be organized as a corporation, partnership or in some other form, that does not conduct commercial banking activities but deals in and/or manages securities and/or other financial instruments as an agent for third parties. It may also conduct such activities as principal (but if it does so exclusively as principal, then it most likely falls within the "Hedge Fund/Proprietary Trader" category above.) Its business normally includes holding securities and/or other financial instruments for third parties and operating related cash accounts. This type of entity is referred to as a "broker-dealer" in US legislation and as an "investment firm" in EC legislation. | | |
| Investment Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide investors with a share in profits or income arising from property acquired, held, managed or disposed of by the manager(s) of the legal entity or arrangement or a right to payment determined by reference to such profits or income. This type of entity or arrangement is referred to as a "collective investment scheme" in EC legislation. It may be regulated or unregulated. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by general law and/or, typically in the case of regulated Investment Funds, financial services legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Investment Fund (for example, a trustee of a unit trust) contract on behalf of the Investment Fund, are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement. | | |

| Description | Covered by opinion | Legal form(s)[2] |
|---|---|---|
| Local Authority. A legal entity established to administer the functions of local government in a particular region within a Sovereign or State of a Federal Sovereign, for example, a city, county, borough or similar area. | | |
| Partnership. A legal entity or form of arrangement without legal personality that is (a) organised as a general, limited or some other form of partnership and (b) does not fall within one of the other categories in this Appendix B. If it does not have legal personality, it may nonetheless be treated as though it were a legal person for certain purposes (for example, for insolvency purposes) and not for other purposes (for example, tax or personal liability). | | |
| Pension Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide pension benefits to a specific class of beneficiaries, normally sponsored by an employer or group of employers. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by pensions legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Pension Fund (for example, a trustee of a pension scheme in the form of a common law trust) contract on behalf of the Pension Fund and are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement. | | |
| Sovereign. A sovereign nation state recognized internationally as such, typically acting through a direct agency or instrumentality of the central government without separate legal personality, for example, the ministry of finance, treasury or national debt office. This category does not include a State of a Federal Sovereign or other political sub-division of a sovereign nation state if the sub-division has separate legal personality (for example, a Local Authority) and it does not include any | | |

| Description | Covered by opinion | Legal form(s)[2] |
|---|---|---|
| legal entity owned by a sovereign nation state (see "Sovereign-owned Entity"). | | |
| Sovereign Wealth Fund. A legal entity, often created by a special statute and normally wholly owned by a Sovereign, established to manage assets of or on behalf of the Sovereign, which may or may not hold those assets in its own name. Such an entity is often referred to as an "investment authority". For certain Sovereigns, this function is performed by the Central Bank, however for purposes of this Appendix B the term "Sovereign Wealth Fund" excludes a Central Bank. | | |
| Sovereign-Owned Entity. A legal entity wholly or majority-owned by a Sovereign, other than a Central Bank, or by a State of a Federal Sovereign, which may or may not benefit from any immunity enjoyed by the Sovereign or State of a Federal Sovereign from legal proceedings or execution against its assets. This category may include entities active entirely in the private sector without any specific public duties or public sector mission as well as statutory bodies with public duties (for example, a statutory body charged with regulatory responsibility over a sector of the domestic economy). This category does not include local governmental authorities (see "Local Authority"). | | |
| State of a Federal Sovereign. The principal political sub-division of a federal Sovereign, such as Australia (for example, Queensland), Canada (for example, Ontario), Germany (for example, Nordrhein-Westfalen) or the United States of America (for example, Pennsylvania). This category does not include a Local Authority. | | |