MEMORANDUM OF LAW

FOR THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. AND

THE FUTURES INDUSTRY ASSOCIATION

ENFORCEABILITY UPON A CUSTOMER'S INSOLVENCY OR OTHER DEFAULT OF THE POSITION LIQUIDATION, MARGIN LIQUIDATION AND DETERMINATION OF ACCOUNT PROVISIONS OF A CUSTOMER AGREEMENT PURSUANT TO WHICH A US FUTURES COMMISSION MERCHANT CLEARS FUTURES AND/OR CLEARED SWAPS FOR THE CUSTOMER

10 March 2025

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1 Introduction

1.1 This Memorandum of law deals with the enforceability upon a customer's insolvency or other default of the Position Liquidation, Margin Liquidation and Determination of Account provisions (collectively, "**remedial provisions**") of a customer agreement (the "**Covered Agreement**") pursuant to which a US futures commission merchant (the "**FCM**") registered with the Commodity Futures Trading Commission (the "**CFTC**") clears Futures and/or Cleared Swaps for a customer located in the Cayman Islands (the "**Covered Customer**").

1.2 We understand that a Covered Agreement generally consists of (1) customer account agreement (a "**Base Account Agreement**") if the Covered Customer trades only Futures, and (2) a Base Account Agreement and a Cleared Derivatives Addendum substantially in the form published by FIA and ISDA in 2012 or 2018 (either, the "**CDA**") if the Covered Customer trades only Cleared Swaps or trades both Futures and Cleared Swaps.

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

1.3.1 a company, including any exempted company (including a segregated portfolio company), ordinary resident company, ordinary non-resident company and limited duration company (the "**Company**") incorporated under the Companies Act (As Revised) (the "**Companies Act**");

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 limited liability companies (each, an "**LLC**") formed under the laws of the Cayman Islands under the Limited Liability Companies Act (As Revised) (the "**LLC Act**");

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

1.3.5 an exempted limited partnership (an "**Exempted Limited Partnership**") established under the Exempted Limited Partnership Act (As Revised) (the "**Exempted Limited Partnership Act**") or a limited partnership (together with an Exempted Limited Partnership, each a "**Partnership**"), established under the Partnership Act (As Revised) (the "**Partnership Act**"), 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 summary annex, attached to this Memorandum as appendix b.

1.5 This Memorandum addresses the efficacy and enforceability of a Base Account 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 Base Account Agreement and 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 Assumptions

2.1 We have relied upon the following assumptions, which we have not independently verified:

2.1.1 the Covered Contracts entered into by the Customer through the FCM pursuant to the Base Account 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;

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

2.1.3 the Customer is not acting as a multi-branch party in entering into the Base Account Agreement or the CDA;

2.1.4 subject to the opinions contained herein, a Base Account Agreement, each Covered Contract, 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;

2.1.5 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 Base Account Agreement, each CDA and any respective amendments of such documents;

2.1.6 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 Base Account Agreement, CDA, US Futures, Cleared Swaps and/or Foreign Futures 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 Base Account 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 Base Account Agreement and CDA with

the FCM and to enter into US Futures, Cleared Swaps and/or Foreign Futures; (b) all of the agent or attorney in fact's activities in connection with a Base Account Agreement, a CDA, any amendments thereto and any US Futures, Cleared Swaps and/or Foreign Futures are within the scope of its agency or power of attorney; (c) US Futures, Cleared Swaps and/or Foreign Futures 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 US Futures, Cleared Swaps and/or Foreign Futures 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 Base Account Agreement, Customer Account, Futures Transactions, CDA, Base Account Agreement or Cleared Swaps, 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;

2.1.7 in so far as any obligation under the Base Account Agreement, any CDA or any Covered Contract, (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;

2.1.8 the Base Account Agreement, any CDA and any Covered Contract 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;

2.1.9 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;

2.1.10 factual representations, warranties and undertakings contained in the Base Account Agreement and any CDA will be accurate and complied with and all preconditions of the parties to the Base Account Agreement and any CDA have been satisfied or duly waived; and

2.1.11 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.

2.2 For purposes of this Memorandum, (1) "**Position Liquidation"** includes hedging by the FCM of risk incurred by the FCM in connection with the Covered Customer's Event of Default (as well as the FCM's close-out or other liquidation of the Covered Customer's open positions in Covered Contracts) and (2) "**Margin Liquidation"** refers to the sale, liquidation or other disposition of securities only (and not also to the sale, liquidation or other disposition of any non-cash assets other than securities).

3 Issues

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

3.1 The parties' agreement on Governing Law of each Base Account 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 Base Account 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 Base Account Agreement and CDA. This would be the system of law with which the transaction is most closely connected.

Would the Position Liquidation provisions of each of the Base Account Agreement and the CDA be enforceable under the laws of your jurisdiction and each of the Position Liquidation methods described in Section XI of the S&C Memo and paragraph 2.4 of the Summary Annex be recognized and upheld by a court 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.

3.2 We believe that effective 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 Position Liquidation would be enforceable under the law of the Cayman Islands in voluntary or involuntary winding up or other insolvency proceedings of the Covered 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 Position Liquidation for the account of the customer.

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

3.3.1 the Companies Act: this is the principal law under which (i) a Company, (ii) a foreign company falling within Section 91 of the Companies Act, (iii) in certain circumstances a LLC and (iv) in certain circumstances, an Exempted Limited Partnership, are subject

[1] In respect of Companies and Exempted Limited Partnerships, support for this position is found in Section 140(2) of the Companies Act (As Revised). 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.

to insolvency proceedings (these are winding up proceedings[2] and the appointment of restructuring officers[3]);

3.3.2 the Bankruptcy Act (As Revised) (the "**Bankruptcy Act**"): the Bankruptcy Act 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 Act 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 Act. 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 Act cannot be made against a Company or LLC – the procedure for winding up Companies or LLCs is provided for in the Companies Act and/or the LLC Act) 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 Act 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 Act); and

3.3.3 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 Act (As Revised) (the "**Banks and Trust Companies Act**"), the Mutual Funds Act (As Revised), the Securities Investment Business Act (As Revised) and the Insurance Act (As Revised) (the "**Insurance Act**")): such laws make provision for the 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 Act 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 Act. 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 Act, 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

[2] In the case of Exempted Limited Partnerships, except to the extent that the Companies Act is inconsistent with the Exempted Limited Partnership Act or there are any express provisions to the contrary, certain provisions of Part 5 of the Companies Act relating to the winding-up of a Company apply to Exempted Limited Partnerships as if each reference in Part 5 of the Companies Act to a "Company" were instead to an "Exempted Limited Partnership". Further under the Exempted Limited Partnership Act the court has been given a general power, upon the application of a partner or creditor, 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.

[3] See paragraph 3.4 of this opinion letter for further details on the restructuring officer regime. In our view, the restructuring officer regime is not strictly an insolvency proceeding as, although restructuring officers are appointed in circumstances where the entity is or is likely to become unable to pay its debts, the purpose of the proceeding is company rescue.

and in such winding up the provisions of the Companies Act relating to the winding up of a Company would 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 relevant provisions of the Companies Act.

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

3.4 Appointment of Restructuring Officers

3.4.1 A Cayman Islands Company can present a petition to the court for the appointment of a restructuring officer. Restructuring officers can be appointed by the court where the Company is or is likely to become unable to pay its debts and intends to present a compromise or arrangement to its creditors (or classes thereof) (the compromise or arrangement can take the form of a Cayman Islands scheme of arrangement, foreign restructuring proceedings (e.g. chapter 11 or a scheme of arrangement in another jurisdiction) or a consensual deal with creditors). On the presentation of the petition, the Cayman Islands Company obtains a stay on legal proceedings being continued or commenced by unsecured creditors against the Cayman Islands Company and this stay, as a matter of Cayman Islands law, has worldwide application. The stay does not prevent a secured creditor from enforcing its security.

3.4.2 Further, upon the presentation of a petition for the appointment of a restructuring officer, the stay on unsecured creditors bringing proceedings against the Company in section 91G(1) of the Companies Act will not prevent creditors from exercising valid and enforceable contractual rights of set-off or netting. The stay only extends to judicial proceedings and does not prevent creditors from enforcing valid and enforceable contractual rights outside of judicial proceedings. The same caveats as set out in sections 3.15 and **Error! Reference source not found.** below would apply.

Would the FCM's holding of the Covered Contracts as an "agent-trust" be recognized by a court in the Cayman Islands as creating a valid trust over the Covered Contracts or would the court otherwise recognize the FCM's legal title to, and the Covered Customer's beneficial interest in, the Covered Contracts?

3.5 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.

If so, would the court characterise Position Liquidation as the FCM's exercising its contractual rights as principal vis-à-vis the DCO under the relevant DCO rules (or vis-à-vis the Foreign Futures Broker under the clearing agreement between the FCM and Foreign Futures Broker) and not as the FCM's acting as the Covered Customer's agent or as the FCM's enforcing its security interest in the Covered Contracts?

Provided that under the Governing Law the Customer assets are held on the "agent-trust" by the FCM for the benefit of the Covered Customer, then, Position Liquidation should be characterised as the FCM exercising its contractual rights as principal for its obligations.

Could the FCM's holding of the Covered Customer's Contracts be characterized as some alternative arrangement, such as a commission agency or as a collateral security arrangement? If so, how would the FCM's Position Liquidation be characterized under the laws of your jurisdiction?

3.6 We do not believe that the FCM's holding of the Covered Customer's Contracts would be recharacterised as a commission agency or as creating a security interest on the basis of the assumptions set out in this Memorandum; that is, on the basis that the FCM's holding of the Covered Customer's Contracts and the Governing Law would not recharacterise the FCM's holding of the Covered Customer's Contracts. 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, 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.

Would a court in the Cayman Islands recognize the statutory trust with respect to the Segregated Funds or Separate Account Funds of each Account Class as creating a valid trust over such Segregated Funds or Separate Account Funds, and that under the terms of that trust, the FCM holds the legal title to, and the Covered Customer holds a beneficial interest in, the statutory trust as a whole (as opposed to maintaining an interest in any specific assets under the trust)? Could the statutory trust with respect to the Segregated Funds or Separate Account Funds of any Account Class be characterized as some alternative arrangement (e.g., as a collateral security arrangement)?

3.7 Yes, the statutory trust would be upheld in the Cayman Islands, assuming such statutory trust is legal, valid, binding and enforceable as a matter of New York law as their governing law. We do not believe the statutory trust would be characterized as some alternative arrangement.

Would the Margin Liquidation provisions of each of the Base Account Agreement and CDA be enforceable under the laws of the Cayman Islands and the FCM's Margin Liquidation in respect of each Account Class be recognized and upheld by a court in your jurisdiction? Could such Margin Liquidation be capable of exercise based on the FCM's exercise of its right under the applicable Customer Property Rules to withdraw and apply Segregated Funds or Separate Account Funds, as the case may be, for Permitted Uses (the FCM's "Permitted Uses Rights") rather than by the enforcement of its security interest in the Covered Customer's Collateral consisting of securities?

3.8 Yes, the Margin Liquidation provisions would be upheld in the Cayman Islands, assuming such Margin Liquidation provisions are legal, valid, binding and enforceable as a matter of New York law as their governing law.

Would the Determination of Account provisions of each of the Base Account Agreement and CDA be enforceable under the laws of your jurisdiction and the FCM's Determination of Account in respect of (i) each Account Class and (ii) all Account Classes on a combined basis be recognized and upheld by a court in your jurisdiction and if so, how could each Determination of Account be characterized (e.g., contractual accounting, netting or set-off, enforcement of the security interest in cash Collateral or some combination of the foregoing)?

3.9 Subject to the below discussion, we believe that the Determination of Account provisions would be respected in the Cayman Islands and each Determination of Account would be characterized in accordance with the New York law as the governing law of each of the Base Account Agreement and CDA.

Contractual Accounting

3.10 The Determination of Account provisions may be regarded as a mere contractual accounting between the parties providing for the calculation of liquidated damages or an agreed termination payment rather than as a set-off subject to applicable insolvency rules including

any requirement for *pari passu* distribution of the assets of the Customer. Such calculation is effective under Cayman Islands law if it is a genuine and reasonable pre-estimate of each party's loss: if it constitutes a penalty, it will not be enforceable. The contractual accounting analysis would require that, under the Governing Law:

3.10.1 all the Transactions constitute one agreement between the Customer and the Counterparty (this is expressly provided for in each of the Base Account Agreement and CDA);

3.10.2 the Transactions are entirely executory or are conditional obligations (this requirement will not be satisfied therefore to the extent obligations have fallen unconditionally due prior to the termination date);

3.10.3 in the event of the insolvency of the Customer giving rise to an Event of Default the effect of the Determination of Account provisions under the Governing Law is to provide for the calculation of damages or for a contractually agreed payment due on early termination and not to create debts between the parties which are then offset; and

3.10.4 the Determination of Account provisions take into account all the Transactions, as the case may be, under the Base Account Agreement and the CDA in calculating the liquidated damages or agreed contractual amount payable by either party.

3.11 If the Determination of Account provisions cannot be analysed as a contractual accounting following the termination of obligations the following paragraphs consider the enforceability of the provisions on the basis of netting and/or set off (as relevant) (the analysis is different depending upon whether the Customer is a Company, a LLC, a Trustee acting as trustee of a Trust or a Partnership acting by its General Partner).

Netting and set-off - Companies and Exempted Limited Partnerships

3.12 Agreements for the netting or set-off claims are generally effective in a winding up of a Company, LLC or Exempted Limited Partnership. This is the case even where the netting or set-off is multi-lateral.

3.13 Upon the winding up of a Company, Section 140(2) of the Companies Act provides, inter alios, that the collection in and application of the property of a Company is without prejudice to and after taking into account and giving effect 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), provided always that any such agreement between the Company and any person or persons has not been waived or limited in any way. Likewise, Section 38(2) of the LLC Act provides a similar provision in respect of LLC counterparties.

3.14 In accordance with the Exempted Limited Partnership Act and the LLC Act, Section 140(2) of the Companies Act also applies upon the winding up of an Exempted Limited Partnership and LLC.

3.15 We believe that the Determination of Account provisions would constitute an agreement for the netting or set-off of claims falling within Section 140(2) of the Companies Act which would be effective and enforceable on the winding up of a Company, a LLC or an Exempted Limited Partnership, subject to the following qualifications:

3.15.1 The right of netting or set-off under the Determination of Account provisions will be restricted to the extent that giving effect to such right deprives a secured creditor of one of the parties of a debt over which such creditor has taken security in circumstances where the security taken over the debt is not subject to the right of netting or set-off under the Determination of Account provisions. In practice as the parties rights under the Customer Agreement may not be assigned, charged or otherwise dealt with without the other party's written consent this is unlikely to be an issue. Furthermore, it is difficult to envisage a situation in which a party's rights under the Customer Agreement could be assigned or charged otherwise than subject to the right of set-off contained in the Determination of Account provisions.

3.15.2 If the claim against one of the parties is subordinated or deferred to other creditors, the right to net or set-off under the Determination of Account provisions will be restricted to the extent of such subordination or deferral. In practice, we assume that no agreement to subordinate or defer claims will be entered into by either party or, if one is, that appropriate advice will be is obtained at that time concerning its effect.

Are there any other circumstances in your jurisdiction, including any moratorium, stay, freeze or other consequence of the commencement of an insolvency proceeding, you can foresee that might affect the FCM's ability to exercise Position Liquidation, Margin Liquidation or a Determination of Account in respect of an Account Class or the overall Customer Account (comprising the three Account Classes)?

3.16 No. Under the Companies Act there is no formal corporate rehabilitation procedure as in England and Wales or in the United States that would give a Customer the benefit of moratorium provisions in the payment of its debts, including secured debts. The rights of the counterparty under the Base Account Agreement or CDA would not be subject to any stay or freeze or otherwise be affected by the commencement of the insolvency or winding up of a Customer (if a Company, LLC or Exempted Limited Partnership). A Company, LLC or an Exempted Limited Partnership is subject to voluntary or involuntary winding up proceedings provided for under the Companies Act although it is possible for a court to appoint a provisional liquidator after the presentation of a petition for the winding up of a Company, LLC or an Exempted Limited Partnership but before an order for the winding up of a company is made where, for example, there is an immediate need to take actions to safeguard assets for creditors. There is a growing practice in the Cayman Islands for provisional liquidators to be appointed with the principal objective of preparing a scheme of arrangement with the aim of avoiding a formal winding up in the case of Companies. Although there is an automatic stay of proceedings against a Company or LLC when an order for winding up has been made and there is a discretionary stay on the appointment of a provisional liquidator, the stay does not prevent a secured creditor from enforcing its security or a creditor from exercising rights of set off.

3.17 If a Customer is a partnership (other than an Exempted Limited Partnership) and a provisional or an absolute order has been made against the partnership under the Bankruptcy Act, no creditor shall have any remedy against the property or person of the partnership and all proceedings are stayed. However, this does not affect the power of any secured creditor to realise or otherwise deal with his security. We believe that proceedings under the Bankruptcy Act would not therefore prevent a secured creditor from enforcing their security against a Customer if the Customer is established as a partnership and subject to proceedings under the Bankruptcy Act.

3.18 Under the laws of the Cayman Islands, are any rights or processes available to a creditor of a Covered Customer by which such creditor could make a claim against the Segregated Funds

or Separate Account Funds held subject to the statutory trust (or otherwise in accordance with the Customer Property Rules) in respect of each Account Class or against the Covered Contracts (and any rights in respect thereof) held by the FCM as agent-trustee for the benefit of the Covered Customer and the FCM's other customers in such Account Class as opposed to only having recourse to the final cash balance or single net termination amount that constitutes the Determination of Account for such Account Class or the overall Customer Account (comprising the three Account Classes)?

3.19 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 US Futures, Cleared Swaps and/or Foreign Futures held on the "agent-trust" by the FCM for the benefit of the Covered Customer, then, subject to the general insolvency rights set out 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 the Covered Agreement, the Covered Customer is insolvent and the FCM has determined a lump-sum cash balance or net 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 cash balance or net termination amount in the currency in which it was determined?

3.20 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.

3.21 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 cash balance or net termination amount be proved in insolvency proceedings in the Cayman Islands without conversion into the local currency?

3.22 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.

3.23 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:

3.23.1 is given by a foreign court of competent jurisdiction;

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

3.23.3 is final;

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

3.23.5 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 Position Liquidation, Margin Liquidation or a Determination of Account?

3.24 No. Cayman Islands law would look to honor the terms of any such Position Liquidation, Margin Liquidation, or the operation of the Determination of Account assuming such Position Liquidation, Margin Liquidation or Determination of Account are enforceable as a matter of their governing law.

Creation, Perfection and Enforcement of FCM's Security Interest in Covered Collateral

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

(a) Voidable Preference under the Companies Act – the entry by a Company, an LLC or Exempted Limited Partnership into a Covered Contract 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 Act 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, LLC 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 voidable upon application of the Company's, LLC's or Exempted Limited Partnership's liquidator 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, LLC'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 has 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, LLC or Exempted Limited Partnership or exercise significant influence over the Company, LLC or

Exempted Limited Partnership in making financial and operating decisions. In practice, we believe it is unlikely the Company, LLC or Exempted Limited Partnership's entry into a Covered Contract 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 Act – in accordance with Section 146(2) of the Companies Act, every disposition of property made at an undervalue by or on behalf of a Company, LLC 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 Act (As Revised).

(c) Intention to defraud – if in the course of the winding up of a Company, LLC or Exempted Limited Partnership it appears that any business of the Company, LLC or Exempted Limited Partnership has been carried on with intent to defraud creditors of the Company, LLC, Exempted Limited Partnership 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 Act. Section 147(1) shall apply to Exempted Limited Partnerships or LLCs upon an involuntary winding up or dissolution of such Exempted Limited Partnership or LLC.

(d) The Fraudulent Dispositions Act (As Revised) 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 Act (As Revised) 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 Act 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 Act would apply to Covered Contracts made on arms' length terms or payments or transfers made pursuant to contractual obligations under such Covered Contracts.

(e) There is a further circumstance in which a creditor of a Company or LLC may be made subject to an arrangement or compromise affecting his rights without his consent. A creditor of a Cayman Islands Company or LLC may have a compromise or arrangement imposed upon him under Section 86(1) of the Companies Act or Section 42(1) of the LLC Act, as applicable[4], (a scheme of arrangement), 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

[4] A restructuring officer may also propose a scheme of arrangement in relation to a Company, LLC or ELP pursuant to section 91I of the Companies Act.

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". The filing of a petition to commence the proceedings for creditors and the Court to approve a scheme of arrangement would not however prevent the enforcement of contractual netting/set-off or security rights. However, the approval of the scheme of arrangement may amend such contractual rights of netting/set-off/security rights. Notwithstanding the above, we would expect the Counterparty to receive notice of any scheme of arrangement. As such if the scheme of arrangement proposed was perceived to be detrimental to the Counterparty (for example because the scheme of arrangement sought to interfere with contractual netting and set-off rights or sought to release the whole or any part of the Counterparty's claim) then Counterparty should be able to enforce its contractual rights of set-off or netting or enforce its security rights before any scheme of arrangement is approved by the Court.

(f) The Companies Act also provides for a stay of proceedings against a Cayman Islands Company on the appointment of a provisional liquidator. Following the presentation of a winding up petition against a Cayman Islands Company, LLC or Exempted Limited Partnership, the Cayman Islands Company, LLC or Exempted Limited Partnership or a creditor of the entity may appoint a provisional liquidator before the winding up petition is heard. An automatic moratorium on judicial proceedings being continued or commenced by unsecured creditors against the Cayman Islands Company, Exempted Limited Partnership or LLC would come into effect upon the appointment of a provisional liquidator. It is likely that an application to appoint a provisional liquidator in these circumstances would be made by a creditor of the Cayman Islands Company for the purpose of maintaining the status quo before the hearing of the winding up petition (although it could be made for the purpose of pursuing a restructuring). The stay does not prevent a secured creditor from enforcing its security or from exercising valid and enforceable contractual rights of set off or netting (the stay extends to judicial proceedings only).

(g) Although a Cayman Islands Company may apply to the Court for the appointment of a provisional liquidator where it is appropriate to do so (for example to obtain a stay on unsecured creditor action in the Cayman Islands while a restructuring is pursued within the provisional liquidation), we anticipate that the appointment of a restructuring officer will be preferred to an appointment of a provisional liquidator where the purpose of such an application is to pursue a restructuring of the Cayman Islands Company's debt.

(h) Void dispositions – Section 99 of the Companies Act 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 Contracts or the Company makes a payment under a Covered Contract after the commencement of the Company's winding up without the approval of the Grand Court, such transaction or payment would be void. Section 99 also applies to Exempted Limited Partnerships or LLCs. As a general matter and subject to the facts and circumstances of each individual scenario we do not believe that Section 99 should affect the enforceability of the relevant netting and set-off provisions.

(i) We confirm that a liquidator of an insolvent Company, Exempted Limited Partnership or LLC 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[5]. 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 Contract, 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 Base Account Agreement and CDA will be upheld against a liquidator to the extent that it (together with the Covered Contracts) is construed as a single contract as a matter of the Governing Law.

(j) In the context of proceedings taken against a partner of a partnership under the Bankruptcy Act, there are specific provisions in the Bankruptcy Act which allow a trustee in bankruptcy to disclaim onerous contracts. Whilst we believe that disclaimer could apply to Position Liquidation (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 Base Account Agreement as part of the disposition of collateral over which the FCM has a pre-existing security interest would not be subject to this provision.

Segregated Portfolio Companies

3.26 Whilst segregated portfolio companies are subject to the insolvency provisions of the Companies Act there are particular rules which apply to them which are relevant to insolvency and netting (or set-off). These are discussed below.

3.27 Under Part 14 of the Companies Act, 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 Act, 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

[5] 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.

attributable to a segregated portfolio in accordance with Part 14 and Section 140(2) of the Companies Act (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 14. In the event of any conflict between Section 140(2) and Part 14, Part 14 will prevail.[6]

3.28 As a result of these provisions, we believe that it is not possible to enforce contractual rights such as Position Liquidation and Margin Liquidation (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 or for assets of one segregated portfolio to be used to secure the liabilities of 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 14. 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 Base Account Agreement and CDA may be required to achieve this.

3.29 If multiple transactions are entered into with one segregated portfolio, the usual netting and set-off rules in Section 140(2) of the Companies Act (or, in the absence of winding up proceedings, the usual contractual rules) relating to the collection in and application of the property of the portfolio will continue to apply to the Position Liquidation and Margin Liquidation (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 Contracts entered into with one segregated portfolio apply against those entered into with another.

3.30 As a result of the provisions described above, we believe Part 14 of the Companies Act also prevents the assets of one portfolio being used to secure a liability attributable to another portfolio.

3.31 The court of the Cayman Islands 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 (this has been confirmed as a flexible balance sheet test 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.

3.32 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

[6] The Cayman Islands Courts has clearly indicated that it has jurisdiction to make a winding up order against a segregated portfolio company on the basis that a single segregated portfolio is unable to pay its debts and in circumstances where other segregated portfolios may be solvent. However, we note that: (i) no Court has yet made a winding up order against a segregated portfolio company on this basis; and (ii) if such an order were to be made the expectation is that the Court order would be framed so as to minimise, as far as possible, any disruption or prejudice to the stakeholders in the solvent segregated portfolios. Further, the making of a winding up order in respect of the segregated portfolio company on the basis of the insolvency of one segregated portfolio, does not in of itself affect the statutory ring fencing of assets and liabilities as described in this paragraph.

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. This will not, however, affect a secured creditor's rights under any agreements entered into with the Company, assuming such agreements are valid as a matter of their governing law.

Trusts

The Nature of a Trust

3.33 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. The Trustee (as the legal owner of the trust assets) enters into all agreements in such capacity and for and on behalf of the relevant Trust. A unit trust is a Trust, the beneficiaries' interests in which have been unitised into specific fractional interests but this does not affect the analysis and we will refer to Trust throughout this analysis.

3.34 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.

3.35 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.

3.36 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 that has entered into a Cayman Islands law governed trust deed, is either solvent or subject to winding up proceedings in the Cayman Islands.

3.37 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.

3.38 There are no insolvency proceedings as such in relation to a Trust other than pursuant to the Trustee's right to seek directions from the court.[7] As noted above in relation to Companies, to the extent a Trust is regulated under applicable Cayman Islands regulatory laws, the provisions discussed above relating to the appointment of controllers and liquidators will apply in relation to the Trust.

[7] 2 A Trustee has power to seek advice and directions from the court under Section 48 of the Trustee Act.

Solvent Trust, Insolvent Trustee

3.39 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:

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

3.39.2 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).

3.40 If the Trust is solvent but the Trustee is in winding up proceedings, we believe that the exercise of the Position Liquidation, Margin Liquidation 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 identifiable) 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

3.41 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 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.

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

3.41.2 secondly, on a *pari passu* basis.

In our view, while the position is not entirely certain, it is likely that distributions of an insolvent trust's assets would be made on a *pari passu* basis[8]

[8] In *ETJL v Halabi; ITGL & ors v Fort Trustees* [2022] UKPC 36 the Privy Council considered distributions in respect of an insolvent trust and held, among other things, that (a) a trustee has a right of indemnification, enforceable by a right of lien, which secures, and

3.42 Given the uncertainty as to the correct method of distribution, the Trustee is likely to refer the matter to the court for a determination[9]. 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 the paragraphs below).

3.43 Accordingly whether the trustee elects simply to collect in assets and pay creditors itself or if the trustee makes an application to the Cayman Islands Court for directions, in our view 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 Act) would refuse to enforce the netting and set-off provisions.

3.44 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 Act (As Revised) would refuse to enforce the Position Liquidation and Margin Liquidation, including the Determination of Account, under the Base Account Agreement and the CDA.

Insolvent Trust, Insolvent Trustee

3.45 If the Trust is insolvent and the Trustee is subject to winding up proceedings, then whilst the analysis above 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 Act (As Revised) 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 3.41 to 3.44 above). In our view, while the position is not entirely certain, it is likely that distributions of an insolvent trust's assets would be made on a *pari passu* basis. See footnote 8.

3.46 If following consideration of the Position Liquidation, including the Determination of Account, under the Base Account 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 Position Liquidation, including the Determination of Account, and respect the contractual agreement between the parties.

3.47 Although the position is not entirely clear, we believe that mutuality is a general requirement for set off under Cayman Islands law and this raises the question whether set off, in the context of an insolvent Trust and Trustee, is restricted by the absence of mutuality. The absence of mutuality arises, if at all, because the Trustee is personally liable for obligations related to the Trust but holds the assets, which includes the benefit of any claims, on trust for the beneficiaries. Whilst the necessary mutuality exists in one sense in respect of the claims

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may be relied upon to recover from the trust assets, all of the liabilities which the trustee may incur throughout its period of acting as trustee; and (b) a *pari passu* basis of distribution applied as between former and successor trustees in respect of this proprietary right to be indemnified. Although this decision focussed on the distribution of assets of an insolvent trust to trustees, Lord Briggs made an obiter comment that creditors of an insolvent trust generally share *pari passu* and this statement is expected to be persuasive. Further, it should be noted that the New Zealand and Australian courts have applied a *pari passu* basis of distribution.

[9] A Trustee has power to seek advice and directions from the court under Section 48 of the Trusts Act (As Revised).

arising under the Customer Agreement, because they are assets and liabilities of the Trust, such assets and liabilities would not necessarily be beneficially owned by or wholly the liability of the Trustee.[10]

3.48 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 Position Liquidation and Margin Liquidation, including the Determination of Account, under the Base Account Agreement and the CDA either because no insolvency rules apply to the Trust (and therefore 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

3.49 The general insolvency issues discussed above in relation to Companies and, in some cases, Exempted Limited Partnerships or LLCs, will apply to the Trustee.

Partnerships

The Nature of a Partnership

3.50 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 Act or the Exempted Limited Partnership Act, as appropriate. However, a winding up petition can be issued against an Exempted Limited Partnership under Section 36(3) of the Exempted Limited Partnership Act. Both creditors and limited partners of the Exempted Limited Partnership have standing to file a winding up petition against an Exempted Limited Partnership. It should be noted that at least one General Partner of an exempted limited partnership formed under the Exempted Limited Partnership Act must be either incorporated in the Cayman Islands, an exempted limited partnership, a foreign company registered in the Cayman Islands, a foreign limited partnership registered in the Cayman Islands or an individual resident in the Cayman Islands.

3.51 For Partnerships other than Exempted Limited Partnerships, there are no statutory insolvency proceedings other than certain provisions in the Bankruptcy Act (As Revised) and, in the case of exempted limited partnerships, a general power given to the court under the Exempted Limited Partnership Act 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

[10] It is arguable that the Trustee's right of indemnity under the Trusts Act (As Revised) (or under an express provision in the trust deed) may give the Trustee sufficient interest in the trust's assets to establish the necessary mutuality but this is an uncertain area.

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 Position Liquidation and Margin Liquidation, including the Determination of Account. The following discussion assumes that the General Partner is incorporated in the Cayman Islands.

Bankruptcy Act

3.52 The Bankruptcy Act allows proceedings to be taken against partners in the name of a Partnership. A bankruptcy petition presented against a Partnership under the Bankruptcy Act 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 Act. 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 Act – the procedure for winding up companies incorporated in the Cayman Islands is provided for in the Companies Act) 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 Act 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 Act). It should be noted that to the extent that proceedings are taken under the Bankruptcy Act set-off would be mandatory under Section 127 of the Bankruptcy Act in respect of mutual credits, mutual debts and other amounts due between the Customer and a FCM under each Base Account Agreement as a result of mutual dealings.

Partnerships, excluding Exempted Limited Partnerships

Solvent Partnership, Insolvent General Partner

3.53 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 Position Liquidation and Margin Liquidation 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[11]. 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

[11] Section 16(1) of the Exempted Limited Partnership Act 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 Act 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.

3.54 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.

3.55 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 Act, such General Partner will be subject to the statutory rights provided by Section 140 of the Companies Act, or in the case of a LLC, Section 38(2) of the LLC Act. Accordingly, subject to the qualifications discussed above, any contractual rights of calculation and determination of the Determination of Account by the exercise of the Position Liquidation and Margin Liquidation would be respected.

3.56 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 Act 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 Act and the Companies Act 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 allow the Determination of Account by the exercise of the Position Liquidation and Margin Liquidation and respect the contractual agreement between the parties.

3.57 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)[12] 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 Position Liquidation and Margin Liquidation, 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

3.58 If the Partnership, not being an Exempted Limited 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 the paragraphs above. As the General Partner is not in winding up the basis of any possible insolvency proceedings is limited to orders sought under the Partnership Act.

[12] 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).

Changes to Partners

3.59 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 Act, 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 Act (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

3.60 The general insolvency issues discussed above in relation to Companies and, in some cases, Exempted Limited Partnerships and LLCs, 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 Act.

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

3.62 Section 111(1) of the Bankruptcy Act makes void any fraudulent preference in similar circumstances to voidable preferences under Section 145(1) of the Companies Act 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 Act 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 Act 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 Act.

3.63 Sections 105 and 106 of the Bankruptcy Act 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. Whilst, in our view, a 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

3.64 The term "enforceable" means that the obligations assumed by the Customer under the Covered 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:

3.64.1 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;

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

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

3.64.4 a determination or calculation of any party to the Base Account 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;

3.64.5 arrangements that constitute penalties will not be enforceable; and

3.64.6 enforcement or performance of any provision in a Covered Agreement which relates, directly or indirectly, to an interest in a Cayman Islands "legal person" (as defined in the Beneficial Ownership Transparency Act (As Revised) ("**BOT Act**")[13]) constituting partnership interests, shares, voting rights or ultimate effective control over management in respect of such legal person may be prohibited or restricted if any such relevant interest is or becomes subject to a restrictions notice issued under the BOT Act. A restrictions notice shall not take effect with respect to a "relevant interest" (as defined in the BOT Act) in a legal person where such relevant interest is subject to a pre-existing security interest granted to a third party who is not affiliated with such legal person.

[13] A Customer (other than a branch established or located in the Cayman Islands of a company incorporated or organised outside the Cayman Islands) is considered a "legal person" under the BOT Act.

3.65 The obligations of a party under a Covered Agreement may be subject to restrictions pursuant to:

3.65.1 United Nations and United Kingdom sanctions extended to the Cayman Islands by Orders in Council; and

3.65.2 sanctions imposed by Cayman Islands authorities under Cayman Islands legislation.

3.66 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 Act) would automatically cause the termination of any agency appointment made by or on behalf of a Company under or pursuant to a Base Account Agreement or a CDA (unless that was a term of the Base Account Agreement or CDA). However, based on English case law (which would be persuasive but not binding in the Cayman Islands[14]), we believe that the appointment of either an official or provisional liquidator in accordance with the Companies Act will result in the termination of any agency appointment made by or on behalf of a Customer under or pursuant to a Base Account 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 Base Account Agreement or CDA or the enforceability of any security interests under the Base Account Agreement or CDA.

Customers regulated under Cayman Islands Regulatory Laws

3.67 The provisions of Cayman Islands regulatory laws providing for the appointment of controllers and liquidators[15] 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 Act [16].

4 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:

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

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

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

4.4 For the foregoing purposes:

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

[15] See the discussion in paragraphs 3.3.3 - 3.17

[16] Under certain of the regulatory laws (e.g. the Mutual Funds Act (As Revised) 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 Act 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.

4.4.1 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;

4.4.2 the "Location" of the Covered 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

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

5 Collateral: Background Information and Assumptions

In addition to the general assumptions contained in paragraph 2, we further understand and assume that:

5.1 "**Covered Collateral**" means the Covered Customer's Collateral consisting of (1) the Customer Account, (2) the Covered Customer's Covered Contracts, (3) cash credited to an account (as opposed to physical notes and coins) and (4) the types of securities that are identified below and that are located or deemed located either (i) in the Cayman Islands, or (ii) outside the Cayman Islands ("**Eligible Collateral**").

5.2 Covered Collateral in the form of cash is denominated in a freely convertible currency and is credited to an account under the "control" of the FCM for purposes of the New York Uniform Commercial Code (the "UCC"), as described in paragraph 1.40 of the Summary Annex.

5.3 any securities considered to be Covered 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 the FCM as Collateral under the Covered Agreement, held directly in this form by the FCM or a DCO (that is, not held by the FCM indirectly through 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 the FCM as Collateral under the Covered Agreement, held directly in this form by the FCM so that the FCM is shown as the relevant holder in the register for such securities (that is, not held by the FCM indirectly with an Intermediary);

(iii) directly held dematerialized debt securities: by this we mean debt securities issued in dematerialized form and, when held by the FCM as Collateral under the Covered Agreement, held directly in this form by the FCM so that the FCM is shown as the relevant holder in the electronic register for such securities (that is, not held by the FCM 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 where such interest has been credited to the account of the FCM n connection with a deposit of Collateral by the Covered Customer with the FCM under the Covered Agreement;

5.4 for the purpose of questions in Section 6 below, we assume that after the Covered Customer commences clearing under the Covered Agreement and while it has open positions in Covered Contracts, an Event of Default occurs with respect to the Covered Customer, and/or, if applicable, the FCM has designated a date to begin closing out or otherwise liquidating the Covered Contracts as a result thereof (however, an insolvency proceeding has not been instituted); and

5.5 for the purposes of questions in Section 7 below, we assume that the Covered Customer has become subject to insolvency proceedings in the Cayman Islands.

6 Collateral under a Base Account Agreement and CDA: Questions

Creation and perfection of the security interest

Under the laws of the Cayman Islands, what law governs the contractual aspects of the security interest in the various forms of Covered Collateral?

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

6.2 The law which determines the proprietary aspects of a security interest created by the relevant Base Account Agreement and CDA will depend, in part, upon the nature of the Covered Collateral.

6.3 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.

6.4 The applicable law for Covered 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 Covered 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.

6.4.1 Directly held registered debt security: the law of the place where the security is properly recoverable or can be enforced[17]. This is likely to be the location of the register as that is where the question of title will be determined[18]. 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.

6.4.2 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[19].

6.4.3 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 & Collins [20] and it is supported by many of the leading commentators[21] (in relation to English law which would be regarded as persuasive).

6.4.4 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).

6.4.5 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.[22]

6.5 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*[23] 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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[17] *Dicey, Morris & Collins on the Conflict of Laws*, 16th Edition Vol II Rule 136(1).

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

[19] The view finds some support in *Dicey, Morris & Collins*, 16th Edition, Vol II, para 23-041.

[20] See *Dicey, Morris & Collins*, 16th Edition, Vol II, para 23-041 and 25-077.

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

[22] See *Dicey, Morris & Collins* 16th Edition, Volume II, Rule 136(1).

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

Would the courts of the Cayman Islands recognise the validity of a security interest in the different types of Covered Collateral, assuming it is valid under New York law? In answering this question, please bear in mind the different forms in which securities Covered Collateral may be held, as described in the assumptions above. Please indicate, in relation to cash Covered Collateral, if your answer depends on the location of the account in which the relevant deposit obligations are recorded and/or upon the currency of those obligations.

6.6 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 Covered 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 Base Account Agreement and CDA and that all appropriate steps had been taken in accordance with the rules outlined in paragraphs 6.8 – 6.14.

6.7 In accordance with Section 142(1) of the Companies Act and Section 36(4) of the Exempted Limited Partnership Act, 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 any cash or securities Covered Collateral subject to the security interest will fluctuate under the Covered Agreement (including as a result of entering into additional Covered Contracts 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 Covered Collateral (that is, Covered Collateral not yet delivered to the relevant party at the time of entry into the relevant Covered Agreement)?

(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 Agreement the specific assets deposited by the Covered Customer with the FCM?

(d) is it necessary under the laws of the Cayman Islands for the amount secured by security interest 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 Customer Collateral in excess of its actual exposure to the Customer under the Covered Agreement?

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

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

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

6.8.3 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).

6.8.4 It is not necessary under Cayman Islands law for the amount secured by the Covered Agreement to be a fixed amount or subject to a fixed maximum amount. It should be noted that if the original Covered Agreement (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.

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

6.9 In relation to future Covered 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 Covered Collateral. Please see paragraph 6.14.5 below.

Assuming that the courts of the Cayman Islands would recognise the security interest in each type of Covered Collateral, 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 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 Covered Collateral which is subject to the security interest.

6.10 The steps required to be taken in the Cayman Islands to perfect the security interest in the Cayman Islands depend upon a number of factors including whether the Covered 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 Covered Collateral and the type of security interest created by the Covered Agreement.

6.11 If the Covered Customer is a Company the Covered Customer is required to record the 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 security interest), the amount of the charge created (or if, as in the case of the Covered Agreement, this is not a fixed amount, a description of the amount secured by the 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 Covered Customer's Register of Mortgages and Charges will become aware of the existence of the 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).

6.12 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 Act 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[24] rather than over assets which it holds beneficially. In the case of a limited partnership or an unlimited partnership established under the Partnership Act 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.

6.13 As mentioned above, it would be necessary to pay Cayman Islands stamp duty if the Covered Agreement 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).

6.14 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[25]), the steps required to perfect the security interest will depend upon a number of factors including the nature of the security interest created[26] and the nature of the Covered Collateral. Dealing with the types of Collateral:

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

6.14.2 directly held registered debt securities: equitable security is perfected by giving notice to the obligor under the rule in *Dearle v Hall*[27]. 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;

6.14.3 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;

[24] See Section 6(2) of the Exempted Limited Partnership Act.

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

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

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

6.14.4 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 Agreement, the FCM must be registered as the holder in the book-entry system; and

6.14.5 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 Act 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 Act 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.[28]

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

6.15 There are no other documentary or formal steps required to ensure the validity and perfection of the security interest contemplated in this Memorandum. It is not necessary as a matter of formal validity that the Covered Agreement 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 security interest). Cayman Islands stamp duty will be payable if the Covered Agreement 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 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 Covered Customer need to take any action thereafter to ensure that the security interest continues to be and/or remains perfected, particularly with respect to additional cash or securities Covered Collateral transferred from time to time when required pursuant to the Covered Agreement?

6.16 There are no additional actions which the FCM or the Covered Customer should take to ensure the security interest continues and/or remains perfected. The necessary steps required under the applicable law(s) to take a perfected security interest in additional Covered Collateral pledged under the Covered Agreement will need to be taken, however, as and when additional Covered 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 Covered Collateral held by it pursuant to the security interest?

6.17 Apart from obligations, duties or limitations imposed under the terms of the relevant Base Account Agreement and CDA or under general New York law or other relevant local law(s) where the Covered Collateral may be held by the FCM, there are no particular duties,

[28] Exempted Limited Partnership Act, Section 31(4)

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.

Do the laws of the Cayman Islands recognize the right of the FCM to use cash or securities Covered Collateral (as described in the assumptions above) pursuant to an agreement with the Covered Customer? In particular, how does such use of the Covered Collateral affect, if at all, the validity, continuity, perfection or priority of the security interest otherwise validly created and perfected prior to such use? Are there any other obligations, duties or limitations imposed on the FCM with respect to its use of the Covered Collateral under the laws of the Cayman Islands?

6.18 Cayman Islands law will recognise a right of the FCM to use the collateral pursuant to the terms agreed in the Covered Agreement 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 security interest otherwise validly created and perfected prior to such use depends upon New York law as the law governing the Covered Agreement and the law which, as a matter of Cayman Islands law, determines proprietary issues.

6.19 If Cayman Islands law is applicable to these issues, for example, because the Covered Collateral is located in the Cayman Islands, the right of the FCM to use the Covered 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 to use the Covered Collateral may be ineffective (this may not affect the rights of any third party however whose entitlement to the Covered Collateral should be determined on the basis of the rules outlined above).

6.20 The right of the FCM to use the Covered Collateral may also constitute a restriction on the equity of redemption as it would prevent the Customer getting back the Covered 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 Agreement void. Furthermore, this may not be an issue where the Covered 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.

7 Enforcement of the security interest in Covered Collateral in the absence of an insolvency proceeding

Assuming that the FCM has obtained a valid and perfected 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 Covered Customer or any other person) or other procedures, if any, that the FCM must observe or undertake in enforcing its security interest as a FCM under the Covered Agreement? For example, is it free to sell the Covered Collateral (including to itself) and apply the proceeds to satisfy the Covered Customer's outstanding obligations under the Covered Agreement? Do such formalities or procedures differ depending on the type of Covered Collateral involved?

7.1 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 Base Account Agreement and CDA (other than those which may be provided for under the terms of the relevant Base Account Agreement and CDA) assuming the same is true as a matter of the Governing Law of the Base Account Agreement and CDA.

7.2 We would note that to the extent the Covered 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 Covered 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 security interest in any type of Covered Collateral 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 security interest?

7.3 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 Covered Collateral. Subject to any debts preferred by law (as discussed above), Section 142(1) of the Companies Act and Section 36(4) of the Exempted Limited Partnership Act 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.

7.4 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 (notwithstanding that the Covered Agreement may not provide for any events of default in respect of the FCM) rather than or in addition to the Covered Customer (for example, would this affect this ability of the FCM to enforce its security interest in Covered Collateral)?

7.5 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 Agreement and CDA and the insolvency laws applicable to the FCM.

8 Enforcement of the security in Covered Collateral 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 security interest in each type of Covered Collateral is to have priority over all other claims (secured or unsecured) of an interest in the Covered Collateral?

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

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

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

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

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

8.2.4 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 Limited Partnership in accordance with Section 32(9) of the Exempted Limited Partnership Act; and

8.2.5 if liquidation 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 enforcement of the security in any type of Covered Collateral after the commencement of an insolvency proceeding be subject to any stay, moratorium 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)?

8.3 The FCM's rights under each Base Account Agreement and CDA would not be subject to any stay or freeze or otherwise be affected by the commencement of the insolvency proceedings[30] or the winding up of the Customer.

8.4 Where the Customer is a Company, Section 97(1) of the Companies Act 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."[31]

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 Act and Section 36(4) of the Exempted Limited Partnership Act 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. Likewise, Section 37(3) of the LLC Act provides a similar provision in respect of a LLC.[32]

It should also be noted that Section 96 of the Companies Act 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

[29] Subject to the statutory exceptions already considered.

[30] Such rights would also not be subject to a stay or freeze or otherwise be affected by the appointment of a restructuring officer.

[31] Analogous provisions exist in relation to the presentation of a petition for the appointment of restructuring officers.

[32] Section 91H of the Companies Act provides that secured creditors may enforce their security notwithstanding that a petition for the appointment of a restructuring officer has been presented or a restructuring officer has been appointed by the Court in respect of the Customer.

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.

8.5 Where the Customer is a Partnership and proceedings are taken under the Bankruptcy Act, 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 Act would not therefore prevent the FCM from enforcing its security against a Partnership.

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

Will the Covered Customer (or its administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official) be able to recover any transfers of Covered Collateral consisting of cash or securities made to the FCM during a certain "suspect period" preceding the date of the insolvency as a result of such transfer constituting a "preference", fraudulent transfer or transaction at an undervalue (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? Would the posting of additional margin (which could be required when an Account's net liquidating equity has fallen below the required margin level for the Account due to trading losses in respect of one of more Covered Contracts) during the suspect period be subject to avoidance, either because the Covered 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

8.7 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

8.8 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 Act 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 voidable upon the application of the Company's, Exempted Limited Partnership's or LLC's liquidator 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.

8.9 Where the Covered Collateral is transferred during the suspect period in substitution for other Collateral and the substitute Collateral is of no greater value than the Covered Collateral it is replacing, Section 145(1) of the Companies Act 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.

8.10 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 Covered 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 Base Account 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 Base Account 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

8.11 In accordance with Section 146(2) of the Companies Act, 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

8.12 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 Act. Section 147 shall only apply to Exempted Limited Partnerships upon an involuntary winding up or dissolution of such Exempted Limited Partnership.

8.13 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

8.14 Section 99 of the Companies Act provides, *inter alia*, that when a winding up order has been made in respect of a Company or 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 Base Account Agreement and CDA; (ii) attempted to substitute Collateral; or (iii) the Covered 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 Covered Collateral consisting of such shares transferred.

Anti-deprivation principle

8.15 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[33]. 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

8.16 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[34] obligations or other contractual consequences arising as a result of the liquidation.

Scheme of arrangement

8.17 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 Act 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

[33] 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.

[34] 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.

compromise affecting his rights without his consent. It would not, however, affect the enforcement of security rights.

Where the Customer is a Partnership

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

Fraudulent preference

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

Disclaimer

8.20 Sections 105 and 106 of the Bankruptcy Act 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 Act had not been made and is therefore able to enforce its security before and after the commencement of bankruptcy proceedings.

Transactions in fraud of creditors

8.21 Under the Fraudulent Dispositions Act (As Revised) 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 Base Account Agreement and CDA if the relevant debtor has the requisite intention at the time of entering into the relevant Base Account Agreement and CDA[35]. 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 Act would be relevant. An action under this law is required to be brought within 6 years of the date of disposition. The Fraudulent Dispositions Act (As Revised) applies whether or not the Customer becomes insolvent and it applies to Companies, Partnerships and Trustees.

Assuming that (a) pursuant to the laws of the Cayman Islands, the laws of another jurisdiction govern the creation and/or perfection of the security interest (for example, because such Covered Collateral is Located or deemed Located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected 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 enforcing its security interest in Covered Collateral?

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

8.23 The FCM will have a valid security interest in the Covered 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.

8.24 As noted above, Section 142(1) of the Companies Act and Section 36(4) of the Exempted Limited Partnership Act 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 discussions above).

9 Additional Considerations

Are there any other Cayman Islands law considerations that you would recommend the FCM to consider in connection with enforcing its security interest in Covered Collateral?

9.2 No.

Are there any other circumstances you can foresee that might affect the FCM's ability to enforce its security interest in the Covered Collateral in the Cayman Islands?

9.3 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

[35] 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

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.

Yours faithfully

Maples and Calder (Cayman) LLP

APPENDIX A

Customer Types

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)).

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).

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 A.

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.

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.

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 A. 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.

Appendix B

Summary Annex

*The following is intended as a high-level overview and summary of the main concepts covered, conclusions reached, and factual assumptions in the Sullivan & Cromwell LLP Memorandum to the Futures Industry Association and the International Swaps And Derivatives Association, Inc. Regarding Futures and Options Transactions, Cleared Swap and Foreign Futures Transactions Executed and Carried by Futures Commission Merchants for Their Customers dated November 17, 2021 (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 all the assumptions, nor the qualifications and detailed reasoning, set out in the S&C Memo. Terms used but not defined in this summary annex have the meanings given to those terms in the S&C Memo or the instruction letter to which this summary annex is attached. Unless otherwise indicated, the references to paragraphs and footnotes in the text below are to paragraphs and footnotes of this summary annex.*

1 Legal relationships between FCM, Customer and DCO (or Foreign Futures Broker) prior to Customer default

The Customer Agreement

1.1 Pursuant to the terms of a customer agreement (the "**Customer Agreement**" or the "**Agreement**") between an FCM and its customer (the "**Customer**"), the FCM maintains one or more accounts on its books and records in the Customer's name (individually or collectively, the "**Customer Account**" or the "**Account**"), and the Customer authorizes the FCM to execute, carry and clear transactions for the purchase and sale of US Futures, Foreign Futures and/or Cleared Swaps Contracts[36] on behalf of the Customer (with respect to the Customer, its "**Contracts**" or "**Transactions**").[37] The effect of this authorization, and the FCM's acceptance, is to cause the FCM to become the Customer's agent for these purposes. A Customer Agreement generally consists of (i) a customer account agreement (a "**Base Account Agreement**"), if the Customer is trading only Futures, (ii) a Base Account Agreement with a cleared derivatives addendum ("**CDA**"), if the Customer is trading only Cleared Swaps or both Futures and Cleared Swaps, and (iii) one or more other documents relating to the terms of the relationship between the FCM and the Customer. The CDA is intended to serve as an addendum to a Base Account Agreement, and all of these documents together form a single agreement that governs the Customer's Account. The Customer Agreement typically provides that the Customer Account and the Customer's Contracts are subject to "applicable law," which is generally defined to include applicable US legislation, rules, regulations and interpretations of regulatory agencies and self-regulatory organizations ("**SROs**") and the rules of trading venues (including exchanges) and clearing organizations where the Customer's Contracts are executed and cleared.[38]

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[36] For purposes of this summary, the instruction letter to which it is annexed and the S&C Memo, "**Futures**" means US Futures and/or Foreign Futures, as the context may require; "**US Futures**" means futures contracts or options on futures contracts cleared by the FCM for a customer through a derivatives clearing organization registered as such (a "**DCO**") with the Commodity Futures Trading Commission (the "**CFTC**") under the Commodity Exchange Act (the "**CEA**"); "**Cleared Swaps**" means swap contracts cleared by the FCM for a customer through a DCO (including single-name credit default swap contracts carried in accounts established in accordance with Section 4d(f) of the CEA pursuant to exemptive relief orders of the CFTC and the Securities and Exchange Commission); "**Foreign Futures**" means futures contracts or options on futures contracts made on or subject to the rules of a foreign board of trade and cleared by the FCM for a customer through a Foreign Futures Broker; and "**Foreign Futures Broker**" means a person that is a member of the foreign board of trade and foreign clearing organization.

[37] The Customer Agreement establishes (i) a debtor-creditor relationship between the FCM and the Customer in respect of the Customer's Account, (ii) the scope and terms of the FCM's authority as agent and the responsibilities of the FCM and the Customer in relation to the Contracts carried by the FCM for the Customer, and (iii) other contractual rights and obligations of the FCM and its Customer relating to their relationship. Some of those other contractual rights and obligations are rights and obligations of the FCM in a principal capacity as the Customer's contractual counterparty, rather in its capacity as the Customer's agent.

[38] Some Customer Agreements also explicitly include the customs and practices of the clearing organizations and trading venues relevant to the Customer's Transactions. In addition, to the extent the Customer Agreement is governed by New York law, it would generally be interpreted in accordance with the customs and practices of the futures industry as a whole, as well as other standard rules of contractual interpretation.

1.2 Under the Customer Agreement, and consistent with its role as the Customer's agent, the FCM is required to account to the Customer for the profits and losses derived from the Customer's Transactions. To the extent that the Transactions carried by the FCM for the Customer generate profits, the FCM is required to account for those profits to the Customer; to the extent that they generate losses, the Customer is required to make the FCM whole for those losses.

1.3 The Customer agrees in its Customer Agreement to (i) deposit and maintain margin with the FCM, (ii) pay the FCM the amount of any trading losses, debit balances or deficiencies (and any applicable interest on those amounts), premiums on options purchased for the Customer, brokerage charges and commissions owed to or incurred by the FCM, charges imposed by exchanges or other SROs relating to the Customer's Contracts or the Customer Account, and other costs arising in the course of the Customer's relationship with the FCM (and the Customer Agreement authorizes the FCM to debit the Customer Account for any of these amounts) and (iii) 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 Customer grants to the FCM a security interest in the Customer Account and the Contracts, money, securities and other property credited to the Account, as discussed in paragraphs 1.36 through 1.41. Events of default applicable to the Customer and related remedial provisions are set out in both the Base Account Agreement and the CDA (if any), as discussed in paragraphs 2.3 and 2.4. A Customer Agreement has no specified term, but may be terminated by either party by written notice. If either party delivers notice of termination of the Customer Agreement (other than as a result of a Customer default), the Customer must promptly instruct the FCM to close its open Contracts or arrange their transfer to another FCM; if the Customer fails to do so, the FCM is entitled to liquidate the Customer's open positions and any other property credited to the Account.

The Customer Account

1.4 The FCM records in the Customer Account all the Contracts entered into by the FCM on behalf of the Customer, as well as debits and credits reflecting margin deposited by or excess margin released to the Customer, realized and unrealized gains and losses on the Customer's Contracts, interest or other income on margin held in the Account, net option values, commissions, amounts payable to introducing brokers, costs relating to physical settlement, fees and other amounts due to or from the Customer in respect of the Account, and any other amounts that may be credited or debited to the Account under the Customer Agreement.

1.5 As discussed in paragraphs 1.12 through 1.24, the CEA and the CFTC's rules with respect to the treatment of cash, securities and other property (collectively, "**funds**") received by the FCM to margin customer contracts, or accruing to customers as the result of their contracts (collectively, "**Customer Funds**"), require the FCM to segregate or set aside those Customer Funds based on the product classes to which they relate (*i.e.*, US Futures, Cleared Swaps or Foreign Futures) and, as a general matter, prohibit commingling of Customer Funds segregated or set aside for one product class with Customer Funds segregated or set aside in respect of any other product class, or with the FCM's proprietary funds (except to the extent of the FCM's residual interest, as described in paragraphs 1.16, 1.18 and 1.20). To ensure books-and-records segregation consistent with these rules, if the Customer clears multiple products, it is treated as having a separate account or sub-account for each product within the Customer Account. Accordingly, as used in this summary annex, with respect to the Customer, (i) "**US Futures Account**," "**Cleared Swaps Account**" and "**Foreign Futures Account**" mean the entries on the FCM's books and records pertaining to the US Futures Customer Funds, Cleared Swaps Customer Funds or Foreign Futures Customer Funds, respectively, of the Customer, (ii) "**Futures Account**" means the Customer's US Futures Account and/or its Foreign Futures Account, as the context may require, (iii) "**Account Class**" means the Customer's US Futures Account, Cleared Swaps Account or Foreign Futures Account and (iv) "**Customer Account**" or "**Account**" may refer, as the context requires, to any Account Class or all Account Classes on a combined basis maintained for a Customer under a Customer Agreement.

1.6 The Customer Agreement establishes the Customer Account as a mutual, open and running account, or mutual open account, between the Customer and the FCM. A mutual open account is an account in which, by agreement of the parties, a connected series of debit and credit entries of reciprocal[39] charges and allowances is to be recorded, and the parties intend that the individual items of the account, once applied to the account, will not be considered independently, but as a continuation of a related series, such that the account balance will increase and decrease as additional related debits and credits are entered and change the account balance until either party wishes to settle and close the account. In other words, as Customer Funds are credited to the Account (whether as margin deposited by, or as gains accruing to, the Customer), and Customer Funds are debited from the Account (whether as charges payable by the Customer or withdrawals to return Customer Funds to the Customer or deliver them to another party), the balance of the account increases or decreases. Moreover, consistent with the common-law view that an account constitutes a claim or demand by one person against another creating a debtor-creditor relationship, the parties intend that the Account represent one single indivisible liability, represented by the Account's balance, owed by one party, as debtor, to the other, as creditor, arising from the series of related and reciprocal debits and credits.[40] Like other types of account agreements, the Customer Agreement generally provides no details as to the operation of the Account or the method by which balances are determined, either pre- or post-default, but such matters may be inferred from both the customs and practices of the industry, the nature of the relationship between the Customer and the FCM and the customer margining standards discussed under "Margining and operation of the Customer Account" in paragraphs 1.25 through 1.30, to which the Account is subject.[41] This balance – the Account's "**net liquidating equity**" – determines, among other things, when the FCM must call for initial and maintenance margin, when the FCM may disburse excess margin upon the Customer's request and how much the FCM must segregate or set aside pursuant to the segregation requirements discussed in paragraphs 1.13 through 1.234. It also serves as the basis for calculating the FCM's claim against the Customer in the event of the Customer's default, and the Customer's claim in the FCM's bankruptcy, as described under "Treatment of customer property in the FCM's bankruptcy" in paragraphs 1.31 through 1.35.

1.7 Under CFTC rules, for purposes of determining the amount that the FCM must segregate or set aside,[42] the Customer's net liquidating equity is equal to the market value of any Customer Funds that the FCM receives from the Customer, as adjusted by (i) any Permitted Uses as described in paragraphs 1.19 and 1.20, (ii) any accruals on permitted investments of such Customer Funds that, pursuant to the Customer Agreement, are creditable to the Customer, (iii) any unrealized gains and losses with respect to the Customer's Contracts, (iv) any charges lawfully accruing to the Customer, including any commission, brokerage fee, interest, tax or storage fee, and (v) any appropriately authorized distribution or transfer of such Customer Funds. In practice, the net liquidating equity reflected in a Customer Account is determined in accordance with customer margining standards (the "**margining standards**") established by a representative committee of SROs, including the National Futures Association and US 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.[43] The margining standards (which address, among other things, when the FCM must call for margin, how excess margin is calculated, when

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[39] In other words, the entries must reflect obligations that are mutual – between the same two parties.

[40] This intention applies both to the transactions executed within a single Account Class, as discussed below, and across Account Classes, because there is a single business relationship between the FCM and Customer with respect to all Account Classes, and a single account maintained for the Customer under the Customer Agreement, of which all Account Classes form a part.

[41] The Account is subject to these requirements both by law and regulation, which mandate these aspects of the manner in which Customer Accounts are managed, and by the Customer Agreement, which (as noted above) is expressly made subject to "applicable law" and frequently contains an express acknowledgement of the margin requirements specifically.

[42] As discussed in footnote 23, a different formulation of "net liquidating equity" is used for purposes of determining the amount of margin that the Customer must deposit at any time. However, the result of both definitions is to ensure that the FCM receives sufficient margin from the Customer to satisfy the Customer's obligations in respect of the positions cleared and carried for it by the FCM, and that the FCM segregates or sets aside and maintains sufficient funds to satisfy the net liquidating equity of all its customers.

[43] This committee is referred to as the "**Joint Audit Committee**."

it may be disbursed to the Customer and how to compute net liquidating equity for margining purposes) represent "applicable law" to which the Customer Account and Contracts are subject, as described in footnote 41, 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. See paragraphs 1.27 through 1.30 for further information as to how the net liquidating equity of a Customer Account is calculated for margining purposes.

Customer Contracts

Assumed clearing relationships and[44] *account structures*

1.8 The S&C Memo addresses the circumstance in which the FCM clears US Futures and Cleared Swaps for the Customer through a DCO as a direct member of the DCO, such that the FCM is interposed between the DCO and Customer in the clearing chain. See the S&C Memo, Section VI. In the case of Foreign Futures, it is assumed that the FCM utilizes a Foreign Futures Broker (which may be an affiliate of the FCM) to execute the Foreign Futures of the Customer (which may be either a US or non-US person) on a Foreign Futures exchange and to clear them through a foreign clearing organization (as a direct member of the foreign clearing organization). See the S&C Memo, Section VII.

1.9 When the FCM clears a US Future or Cleared Swap for the Customer, the FCM clears the Transaction directly with the DCO, which credits the Transaction to an omnibus customer positions account of the FCM at the DCO maintained in the name of the FCM for the benefit of its customers in the relevant Account Class.[45] The FCM, in turn, credits the transaction to the Customer's account on the FCM's books. Similarly, in the case of the Customer's Foreign Futures, the Foreign Futures Broker clears the Transaction with the relevant foreign clearing organization, which credits the Transaction to an omnibus account with the foreign clearing organization maintained in the name of the Foreign Futures Broker for its customers, and the Foreign Futures Broker, in turn, credits the Transaction to an omnibus customer positions account of the FCM with the Foreign Futures Broker maintained in the name of the FCM for the benefit of its Foreign Futures customers. The FCM, in turn, credits the Transaction to the Customer's Account on the FCM's books. Accordingly, for every Transaction, there are at least two relevant accounts: (i) the Customer's Account on the FCM's books in the name of the Customer to which the FCM credits all Transactions cleared for the Customer by that FCM across all DCOs or foreign clearing organizations, and (ii) an omnibus customer positions account of the FCM at the applicable DCO, or Foreign Futures Broker, to which the FCM's customer transactions for all its customers in the relevant Account Class at that DCO, or Foreign Futures Broker, are credited.

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[44] A "**position**" is "an interest in the market, either long or short, in the form of one or more open contracts." https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/CFTCGlossary/index.htm#P.

[45] In the case of Cleared Swaps, the structure of the omnibus customer positions account is the same as in the case of Futures. However, the FCM is required to provide the DCO, no less frequently than once each business day, information sufficient to identify, for each Cleared Swaps customer, the portfolio of rights and obligations arising from the Cleared Swaps that such FCM intermediates for the customer. 12 C.F.R. § 22.11(c)(2). In addition, the DCO must maintain records, updated no less frequently than once each business day, of (1) the amount of margin required at such DCO for each Cleared Swaps customer of the relevant FCM; and (2) the sum of the all such amounts for all customers of such FCM. 12 C.F.R. § 22.12(c). The DCO is obligated to treat the value of the Customer Funds received from each Cleared Swaps customer as belonging to that Cleared Swaps customer, except that this treatment does not limit the DCO's right to liquidate any or all positions in the omnibus customer positions account upon the default of the FCM. *Id.* § 22.15. As a result, although the Customer Funds of the various customers are commingled in a single omnibus account, they are "legally segregated" by the maintenance of records and rules that allow the DCO and the FMC to track the value of Customer Funds allocable to each customer, and ensure that the funds of one customer are not used to satisfy the obligations arising out of Cleared Swaps allocable to another customer.

FCM as agent-trustee with respect to the Customer's Contracts

1.10 Although in all cases the FCM enters into the Customer's Contracts as the Customer's agent and upon the instruction and for the risk and benefit of the Customer, the FCM's relationship with the DCO or the FCM's Foreign Futures Broker with respect to the Customer's Contracts is treated by the DCO or Foreign Futures Broker as a principal-to-principal relationship. This principal-to-principal relationship is governed by the terms of the DCO's rules and procedures, or by a contractual arrangement between the FCM and the Foreign Futures Broker (which is likely governed by non-US law), to which the FCM's Customer is in neither case a party. The Customer is not in privity of contract with the DCO or Foreign Futures Broker with respect to the Customer's Contracts, neither the DCO nor the Foreign Futures Broker has any liability to the Customer and the Customer has no rights or claims against the DCO or Foreign Futures Broker. Moreover, from a US law perspective, the FCM is not in privity of contract with the foreign clearing organization. The FCM is fully liable as principal for all amounts owing to the DCO or foreign clearing broker in connection with the FCM's Customer Contracts. See the S&C Memo, Sections VI and VII.

1.11 Under these arrangements, the FCM acts as an "**agent-trustee**" of the Customer with respect to the Customer's Contracts. This reflects the fact that, as the sole counterparty and principal obligor to the DCO or Foreign Futures Broker under the Contracts made on the Customer's behalf with the DCO or Foreign Futures Broker,[46] the FCM holds legal title to (*i.e.*, it is the legal owner of) the Contracts credited to the omnibus customer positions account maintained with the DCO or Foreign Futures Broker. The Customer is, however, the beneficial owner (*i.e.*, the owner in equity) of the Contracts credited to the omnibus customer positions account, entitled to their benefit and subject to the burdens of and obligations arising from the Contracts. In other words, these Contracts are held in trust[47] for the Customer by the FCM.[48] The Customer will have a *pro rata* beneficial interest in all the Contracts credited to the FCM's omnibus customer positions accounts, reflecting the Contracts credited to its specific Customer Account, but the Customer will not have an interest in any specific contract as such. The capacity in which the FCM holds Contracts as agent-trustee for the Customer will be distinct from its capacity as agent-trustee for its other customers. See Section VI of the S&C Memo.

Customer Funds

1.12 An FCM is required to segregate Customer Funds – *i.e.*, (i) funds received by the FCM from, for or on behalf of the Customer to margin, guarantee or secure the Customer's US Futures Contracts and Cleared Swaps, and (ii) funds accruing to the Customer as a result of its US Futures and Cleared Swaps. Customer Funds relating to each Account Class must be segregated separately and in accordance with the respective rules for each Account Class. The segregation rules are set out in (i) section 4d(a)(2) of the CEA and CFTC rules 1.20 through 1.30 and 1.32, in the case of Customer Funds of US Futures customers, and (ii) section 4d(f) of the CEA and the CFTC's Part 22 rules, in the case of Customer Funds of Cleared Swaps customers. Similarly, the FCM is

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[46] The precise nature of what the FCM holds for the Customer when it clears a contract through a Foreign Futures Broker will depend on the structure of that contract and the laws governing that contract and the relationship with the Foreign Futures Broker. If the FCM is a party to a contract, it would be an agent-trustee for the Customer in respect of that Contract.

[47] Under US common-law principles, (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.

[48] Notably however, as mentioned in paragraph 2.1, notwithstanding this agent-trustee relationship with respect to the Customer's Contracts, the FCM retains a contractual right under the Customer Agreement, under certain circumstances specified in the Customer Agreement (including certain non-default scenarios), to close out the Contracts in its capacity as the contractual counterparty to the DCO, for its own account as principal and without regard to the directions or interest of the Customer.

required to hold Customer Funds of Foreign Futures customers in "separate accounts" in accordance with the CFTC's Part 30 rules. The separate account rules applicable to Foreign Futures and the segregation rules applicable to US Futures and Cleared Swaps are similar, but are based in different statutory provisions and reflect the different clearing relationships (and risks) involved in Foreign Futures. The CEA statutory provisions and the segregation or separate account rules (collectively, the "**Customer Property Rules**") applicable to each Account Class provide that the FCM may not commingle Customer Funds of customers maintained in such Account Class with funds that are deposited by customers and maintained in accounts pursuant to the rules applicable to the other Account Classes or with the FCM's proprietary funds, unless such commingling is expressly permitted by CFTC rule or order (or by any DCO rule approved by the CFTC).

US Futures and Cleared Swaps

1.13 The respective Customer Property Rules for US Futures and Cleared Swaps require the FCM to treat and deal with the Customer Funds of each of its customers with Contracts in each Account Class as belonging to the customer, separately account for and segregate the Customer Funds from its own assets (other than certain proprietary funds of the FCM contributed by the FCM, which may be commingled with such Customer Funds, as described in paragraph 1.16) and not use such Customer Funds to margin the Contracts or secure or extend the credit of any customer or person other than the customer for whom such Customer Funds are held. The Customer Property Rules for each of these Account Classes specify the amount of property that must be held under the rules, the manner in which the property must be held and the purposes for which the FCM may use the property.

1.14 The FCM may deposit Segregated Funds only with permitted depositories, which are banks or trust companies (in an omnibus account established by the FCM with its bank for the benefit of its customers of the relevant Account Class), DCOs (in the FCM's omnibus customer margin accounts on the books of the DCOs for customers of the relevant Account Class),[49] and other registered FCMs (each, a "**depository**"), in each case with account names that clearly identify the funds therein as belonging to the FCM's customers in the applicable Account Class and show that the funds are segregated as required by the segregation rules for the Account Class. As used in this summary annex, "**Segregated Account**" means, with respect to either US Futures or Cleared Swaps, an account maintained by the FCM with an individual depository to hold Segregated Funds for the benefit of customers in the applicable Account Class, and "**Segregated Funds Account**" means, with respect to either such Account Class, all Segregated Accounts (on a combined basis) maintained by the FCM with all depositories that hold Segregated Funds in respect of the Account Class.

1.15 The respective Customer Property Rules for US Futures and Cleared Swaps result in what US federal courts (both district and appellate) and the CFTC have described as a "technical trust" or "specific statutory trust" over all the Customer Funds held by the FCM for the benefit of its customers in the applicable Account Class, as well as any proprietary funds contributed by the FCM with respect to the Account Class (such Customer Funds and proprietary funds for each Account Class, collectively, the "**Segregated Funds**" for such Account Class). See the S&C Memo, Section VI. The respective statutory trusts for US Futures and Cleared Swaps are distinct from the common-law agent-trustee relationship described above, under which the FCM carries the Contracts. Moreover, the statutory trusts are not common-law trusts, and not subject to common-law fiduciary legal principles. Although similar to a common-law "resulting trust,"[50] the scope of the statutory trusts, and the

[49] The DCO holds the funds of customers of multiple FCMs in a single account with its bank or custodian, but allocates those funds to the respective FCMs on the books of the DCO, in a manner similar to the way in which the FCM commingles funds of multiple customers in the accounts that it maintains with its banks and custodians but credits individual customers with their respective shares of such funds.

[50] A "**resulting trust**" is a type of trust that arises by operation of law when the actions of the parties indicate that money is transferred to a party with the intention that the money is to be kept or used as a separate fund for the benefit of the payor or a third person. The trust carries out and enforces the inferred intent of the parties. The trustee of such a trust "has no duties to perform, no trust

duties of the FCM with respect to the customer property, are determined by the Customer Property Rules for the applicable Account Class.

1.16 The distinction between the nature of the specific statutory trusts and a common law trust is exemplified by several actions that the FCM may take under the respective Customer Property Rules for US Futures and Cleared Swaps, but that would not generally be permitted in relation to a classic common-law trust. First, the Customer Property Rules for each Account Class permit the FCM to invest Customer Funds in certain types of permitted investments specified by the CFTC and retain as its own any resulting income – something that would not be permitted to a common-law trustee.[51] Second, the FCM is permitted to commingle Customer Funds of different customers held in the same Account Class on an omnibus basis in its Segregated Funds Account for the Account Class. Third, the FCM, in accordance with the Customer Property Rules for each Account Class, may deposit and maintain its own funds as a "**residual interest**" in its Segregated Funds Account for the Account Class as a cushion or buffer to protect against becoming undersegregated by failing at any time to hold funds in such accounts sufficient to meet the CFTC's "**segregation requirement**" for the Account Class, as discussed in paragraph 1.18. Fourth, and most fundamentally, the FCM is permitted to use the Segregated Funds that are subject to the statutory trust to satisfy its own obligations to DCOs and other parties in relation to the Customer's Transactions, as discussed in paragraph 1.19. See the S&C Memo, Section VI.

1.17 The primary purpose of the statutory trust, and the Customer Property Rules as a whole, is to ensure that the FCM has sufficient assets, in liquid form, available at all times to satisfy its obligations in respect of its customers' accounts. The segregation requirement was adopted to curb abuses in the handling of Customer Funds that were common practices undertaken by futures commission merchants. Some commission merchants in the futures markets used Customer Funds belonging to one customer to extend credit to more favored customers, or used Customer Funds for their own proprietary trading. These practices often left FCMs without sufficient resources to satisfy their obligations to their customers in respect of their accounts. Today, segregation is also recognized as a key measure protecting the markets, by ensuring the availability of funds to the FCM when required to comply with its obligations to a DCO in respect of the Customer's Transactions.

1.18 Under the Customer Property Rules, the FCM must maintain funds in segregation in an aggregate amount at least sufficient to cover the FCM's "total obligations" to all customers in the relevant Account Class. This amount is equal to the aggregate positive net liquidating equity for every customer in the same Account Class (without reduction for any customer net liquidating equities that are negative). As the FCM must be in compliance with the segregation requirement at all times (because otherwise the FCM would be using funds of one customer to margin positions or cover losses of another customer), the FCM maintains additional funds in the account – its "**residual interest**" in the account after its obligations to customers have been satisfied – to protect against becoming undersegregated at any time.[52] Additionally, as a means of demonstrating compliance with the prohibition on the use of one customer's funds to margin or settle another customer's positions, for each Customer Account whose net liquidating equity is insufficient on any business day to cover the margin required for the Customer's open positions, the FCM must have, prior to specific points in time on the following business day, a residual interest in its Segregated Funds Account in an amount at least equal to the sum of the undermargined amounts of Customer Accounts in the same Account Class. If the FCM discovers at any time that it holds insufficient funds in its Segregated Funds Account for an Account Class to meet its obligations with respect to the segregation requirement or the undermargined amounts requirement for the Account Class, it must

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to administer and no purpose to carry out except the single task of holding onto or conveying the property to the beneficiary." *In re Downey Financial Corp.*, 499 B.R. 439, 468 (Bkrtcy. D. Del. 2013).

[51] The FCM must also segregate, and bears sole responsibility in respect of, the investments and must bear any losses arising from the investment.

[52] The FCM is required to establish and maintain a target residual interest that is in an amount that reasonably ensures that the FCM always remains in compliance with the segregation requirement.

immediately deposit sufficient funds into segregation to bring the account back into compliance. The FCM may make withdrawals from its Segregated Funds for an Account Class that are made to or for the benefit of customers, as described in paragraph 1.19, but may also make withdrawals for its own proprietary uses to the extent of its residual interest and subject to certain limitations and conditions (including a general limitation that any withdrawal of funds not made to or for the benefit of customers must not result in one customer's funds being used to margin or carry the contracts, or extend the credit, of any other customer or person).

1.19 The Customer Property Rules for US Futures and Cleared Swaps expressly permit the FCM to withdraw from segregation and apply Segregated Funds maintained in each Account Class as necessary in the normal course of business to margin, guarantee, secure, transfer, adjust or settle the Customer's Contracts in such Account Class with a DCO or another FCM, including to pay commissions, brokerage, interest, taxes, storage and other charges incurred in connection with the Customer's Contracts ("**Permitted Uses**"). Other costs and expenses that are chargeable to the Customer but not necessary to the execution or maintenance of its Contracts may not be paid directly from Segregated Funds (since that would reduce the Segregated Funds available for distribution to other customers whose funds are maintained in the same Account Class), but they may be charged to the Customer Account by debiting the cash balance in the Account ("**Chargeable Costs**"). By debiting the cash balance, the FCM offsets the Customer's obligation to reimburse the FCM for the Chargeable Costs against the FCM's obligation to repay the cash balance and thereby reduces the Customer's net liquidating equity, and with it the Customer's interest in the funds held in segregation. This reduction in the Customer's interest increases the FCM's residual interest in the Segregated Funds, thereby permitting the FCM (if it is otherwise fully compliant with segregation requirements) to withdraw the corresponding amount of funds from segregation to reimburse itself the amount of the Chargeable Costs (provided that the FCM satisfies the conditions and restrictions for withdrawal of residual interest funds). In practice, the 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 Contracts. See the S&C Memo, Section VI.

Foreign Futures

1.20 The Customer Property Rules for Foreign Futures parallel, but are separate from, the segregation rules for funds maintained in the other two Account Classes. They require the FCM to set aside and maintain in one or more "**Separate Accounts**" funds in an amount, which is denominated as the "foreign futures or foreign options secured amount" (the "**Secured Amount**"), at least sufficient to cover or satisfy all its obligations to Foreign Futures customers, which are defined as the full net liquidating equities owed to them by the FCM. The FCM must deposit the Secured Amount under an account name that clearly identifies the funds as belonging to Foreign Futures customers and shows that the Secured Amount is set aside as required by Part 30. The FCM may deposit funds set aside as the Secured Amount only with permitted depositories, which include banks or trust companies located in the US, banks or trust companies outside the US that have in excess of $1 billion of regulatory capital, registered FCMs or DCOs, foreign clearing organizations of any foreign board of trade, members of any foreign board of trade, or any such member's or clearing organization's designated depositories. The FCM may hold the Secured Amount in separate accounts maintained in non-US depositories outside the US only in an amount sufficient to meet margin requirements established by foreign boards of trade or foreign clearing organizations, or to meet margin calls issued by Foreign Futures Brokers carrying Foreign Futures of the FCM's customers, together with an additional "prefunding" amount to mitigate operational demands. The FCM is prohibited from using the funds of one Foreign Futures customer to purchase, margin or settle the Contracts of, or to secure or extend credit to, any person other than such customer. As with US Futures and Cleared Swaps, the Foreign Futures Customer Property Rules have a "Permitted Uses" provision (set out in CFTC rule 30.7) that expressly permits the FCM to "withdraw funds from [separate accounts] in an amount necessary in the normal course of business to margin, guarantee, secure, transfer or settle [customers' Foreign

Futures positions] with a foreign broker or clearing organization." The Customer Property Rules for Foreign Futures also require the FCM to maintain a residual interest in its Separate Account(s)[53] and permit investment of the amounts held in the Separate Account(s), subject to the FCM accepting liability for losses in a manner similar to the requirements and limitations on the FCM's investment of the funds in a Segregated Account for US Futures or Cleared Swaps. The FCM may not commingle Foreign Futures Customer Funds with its own property, except in accordance with the rules relating to its residual interest in those funds, or with Segregated Funds maintained in the other two Account Classes.

1.21 Prior to amendments to the CFTC's Part 30 rules in 2013, requirements regarding the collateral of Foreign Futures customers were substantially less robust than those established by the 2013 amendments. Among other things, the FCM was required to set aside in separate accounts a secured amount sufficient to cover only the margin required on open positions, plus or minus any unrealized gains or losses on such positions. The FCM was not required to set aside a secured amount sufficient to cover all the FCM's obligations to Foreign Futures customers (*i.e.*, the positive net liquidating equities of all Foreign Futures customers). Any Customer Funds deposited by customers in excess of such amount could be held by the FCM in operating cash accounts and used by the FCM as if they were its capital. Moreover, the FCM was permitted, but was not required, to set aside funds for Foreign Futures customers if they were not US persons.

1.22 The CFTC did not view the pre-2013 Customer Property Rules for Foreign Futures as operating to impose a statutory trust over Foreign Futures Customer Funds. Instead, the CFTC believed the secured amount under the pre-2013 rules represented a security deposit made by the FCM to secure its obligations to its Foreign Futures customers and, unlike US Futures Segregated Funds, did not constitute a trust of funds explicitly denominated as belonging to customers.

1.23 However, the 2013 amendments significantly enhanced the protections afforded Foreign Futures Customer Funds and extended to Foreign Futures customers protections equivalent to those already provided to US Futures customers. The amendments effectively replicated for Foreign Futures the segregation regimes applicable to US Futures (including rights of the FCM, such as the right of Permitted Uses), thereby contributing to the CFTC's stated goal of having customer protections be substantially similar across the three Account Classes. Like the segregation regimes, the new Foreign Futures Customer Funds rules required the funds received by or for the account of Foreign Futures customers to be held in a separate account for the specific purpose of carrying out the customers' business. Based on the current substantial similarities of the three customer property regimes resulting from the 2013 amendments and applying reasoning of courts in cases in which they have found statutory trusts in other regulatory frameworks, the S&C Memo concludes that there is a strong argument that the Foreign Futures Customer Property Rules operate to establish a separate statutory trust over Foreign Futures Customer Funds, although no court or regulator has yet specifically confirmed this view. See the S&C Memo, Section VII.

Implications of Customer Property Rules in respect of customer entitlements

1.24 Under the Customer Property Rules for each Account Class, the claims of customers for their Customer Funds, together with the FCM's residual interest, constitute the entirety of the entitlements to the Segregated Funds or Separate Account funds of such Account Class. The FMC's residual interest, as its name implies, is the remainder of the Segregated Funds or Separate Account Funds of the applicable Account Class after accounting for the aggregate claims of customers to their Customer Funds and is subordinated to the interests of the customers. For purposes of the Customer Property Rules for each Account Class, the extent of each

[53] As used herein, "**Separate Account Funds**" means the funds credited to a Separate Account, including in respect of the FCM's residual interest.

customer's entitlement to the Segregated Funds or Separate Account Funds is limited to a monetary value equal to its net liquidating equity, which the CFTC views as representing the FCM's total obligations to the customer in respect of such Account Class.

Margining and operation of the Customer Account

Example of margining between the FCM and DCOs in respect of US Futures and Cleared Swaps

1.25 When the FCM establishes an open position for the Customer in a US Future or Cleared Swaps Contract cleared by a DCO, the FCM will be required to satisfy the DCO's initial margin requirement for the position. If, at any time at or following the establishment of the open position, the FCM holds insufficient funds of the Customer to fully cover the DCO's margin requirement, the FCM will be required to use its own funds, and then to obtain additional margin in the requisite amount from the Customer. If the open position is closed, the FCM is no longer required to maintain initial margin for it, and unless the funds are needed to margin other positions in the same Account Class cleared by the FCM with the DCO, the DCO will return any initial margin it holds with respect to that position to the FCM's Segregated Account at the settlement bank that it uses in connection with that DCO.[54]

1.26 For each open position of the Customer in a Contract in respect of which the DCO and FCM exchange variation margin amounts,[55] the DCO will (i) at the end of each trading day, 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 gains (or losses) in respect of the position for that trading day,[56] (ii) net that variation margin amount with all other variation margin amounts for all other open positions of the Customer and all other customers in the same Account Class cleared by the FCM at the DCO, and (iii) at or before the opening of the next trading day, deposit to or withdraw from the FCM's Segregated Account at its settlement bank the resulting aggregate net variation margin amount. DCOs are authorized to credit or debit variation margin payments from the FCM's Segregated Account without further action or authorization by the FCM; accordingly, this process occurs without the involvement of the FCM. Any other DCO clearing the Customer's open positions in the same Account Class will conduct a similar variation margin settlement process. Because all these debits and credits are made by

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[54] A DCO will calculate initial margin in respect of an omnibus customer positions account on a "gross" basis equal to the sum of the initial margin amounts that would be required by the DCO for each individual customer within that account as if each customer were a clearing member. However, the DCO and FCM will settle *US Futures* initial margin amounts due on the same day on a net basis, such that initial margin amounts due from customers will be netted against initial margin amounts being released by the DCO to other customers. In contrast, *Cleared Swaps* initial margin amounts are settled on a gross basis. The FCM's customers are divided into those whose initial margin requirements have increased and those whose initial margin requirements have decreased since the prior day, and the FCM must deposit with the DCO the aggregate of the increased initial margin amounts before it is permitted to withdraw the aggregate of the released initial margin amounts.

[55] The DCO and FCM exchange variation margin amounts with respect to all Cleared Swaps and US Futures Contracts, other than options on futures with "equity-style" margining. No variation margin amounts are paid in respect of options with "equity-style" margining prior to the exercise of the options. An upfront premium on an equity-style option is paid from the buyer to the seller (via the DCO) when the option is traded, and the buyer receives a credit net liquidating value ("**NLV**"), equal to the current replacement value of the option, which the buyer can use as collateral to satisfy its initial margin requirements or offset any debit NLV on other equity-style options. Upon receipt of the upfront premium, the seller receives a debit NLV that must be covered by collateral, being either any credit NLV on other equity-style options or cash, securities or other collateral. The value of the NLV – both debit and credit – varies each day with the current fair value of the option. If the option is exercised, the buyer receives the underlying future, and the final NLV becomes the variation margin amount on the resulting futures position. In contrast, for an option on a future with "futures-style" margining, a premium is paid only upon exercise/expiry, not upfront on the trade date, there is no NLV and variation margin amounts are paid on a daily basis during the life of the option.

[56] Variation margin amounts exchanged by a DCO and FCM in respect of US Futures and Cleared Swaps constitute settlement payments that extinguish mark-to-market exposures, rather than transfers of collateral that secure such exposures. However, daily settlement by the FCM and DCO of variation margin amounts in respect of open positions does not result in the positions being considered settled or closed.

each DCO to the FCM's Segregated Funds Account,[57] the variation margin amounts credited by one DCO to the FCM's Segregated Account in respect of the net gains on the Customer's open positions with the DCO may be used to satisfy variation margin amounts for which another DCO debits the Segregated Account in respect of net losses on open positions it clears. The netting of variation margin amounts due to a DCO (in respect of trading losses) and from the same DCO (in respect of trading gains) in respect of the Customer's open positions in Contracts cleared by the DCO, and the use of variation margin amounts received from one DCO (in respect of net trading gains) and to satisfy variation margin requirements payable to another DCO (in respect of net trading losses) in respect of the Customer's open positions in Contracts cleared by each DCO constitute Permitted Uses of Customer Funds to satisfy the Customer's obligations.

Example of margining between the FCM and Customer in respect of US Futures and Cleared Swaps

1.27 If the Customer's net liquidating equity is less than the applicable margin requirement for its Account, the Account is undermargined, and the FCM will call for the Customer to deposit with the FCM additional funds so that the Customer's net liquidating equity at least equals the Customer Account's initial margin requirement.[58] When the Customer meets the margin call, the funds will be deposited in one of the FCM's Segregated Accounts for the applicable Account Class at one of the FCM's settlement banks, and the FCM will credit the Customer's deposit to the cash balance (and/or the non-cash margin balance) of the Customer Account (which will increase the liability of the FCM to the Customer and the Customer's net liquidating equity claim against the FCM's Segregated Funds for such Account Class). The FCM must continue to hold the funds with permitted depositories, as described in paragraph 1.14, including in the FCM's omnibus customer margin accounts for customers of the relevant Account Class on the books of one or more DCOs. Each of the cash and non-cash balances represents funds deposited by the Customer with the FCM and is not adjusted when the FCM deposits initial margin with a DCO, or when the DCO releases initial margin to the FCM, as a result of establishing or closing positions in the Customer's Contracts cleared through the DCO.

1.28 The FCM may call for initial margin from the Customer in respect of a position in an amount greater than the amount of initial margin that the relevant DCO requires from the FCM in respect of the position. The

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[57] As noted above, the FCM may maintain more than one Segregated Account; all the Segregated Accounts (on a combined basis) maintained by the FCM with all depositories that hold Segregated Funds in respect of the Account Class are treated as a single fund relating to the relevant Account Class. Generally, a DCO will designate a limited number of banks or trust companies that they themselves use as settlement banks and the FCM will pick one on the DCO's list as the FCM's settlement bank for that DCO. To the extent possible, the FCM will typically select a settlement bank that it can use across DCOs in respect of the same Account Class and currency. For example, the FCM may select the New York branch of a bank for USD and the London Branch of the bank for currencies other than USD.

[58] For purposes of determining when the Customer must provide additional margin, the Customer's net liquidating equity is equal to the sum of (i) the account's "**open trade equity**" with respect to open positions in Contracts in respect of which the FCM and DCO exchange variation margin amounts (which include futures, Cleared Swaps and options with "futures-style" margining), (ii) the Account's cash balance, (iii) the collateral value of non-cash margin and (iv) for the FCM that does not use the "total equity" method for margining, net option value ("**NOV**") of options in respect of which no daily variation margin amounts are exchanged. A "total equity" method FCM, for margining purposes, does not include NOV in net liquidating equity, and changes in NOV instead result in adjustments to the Customer's initial margin requirement. Open trade equity represents the net cumulative "unrealized" gains and losses in respect of the Customer's positions while they are open (*i.e.*, the open trade equity 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). When the position is closed, the net cumulative gain or loss represented by open trade equity is "realized" by the Customer and the position's open trade equity (which may be less than zero) either increases or decreases the cash balance of the Customer Account (and thereafter is no longer reflected in the Account's open trade equity). The cash balance is increased by, among other things, (1) cash deposited by the Customer as margin with the FCM, (2) the net cumulative gains realized in respect of the Customer's positions with open trade equity when they are closed (which equals the positions' net positive open trade equity immediately prior to their closure) and (3) any other amounts payable to the Customer under the Customer Agreement and is decreased by, among other things, (A) the net cumulative losses realized in respect of the Customer's positions with open trade equity when they are closed (which equals the positions' net negative open trade equity immediately prior to their closure), (B) any permitted withdrawals of excess cash margin from the Account by the Customer and (C) commissions, brokerage fees, taxes, interest and other charges to the Account.

FCM will generally maintain the excess margin in its Segregated Account(s) at the FCM's settlement bank(s), but may also deposit the excess margin with other permitted depositories, including a DCO.

1.29 When the FCM establishes an open position for the Customer in a Contract in respect of which variation margin amounts are exchanged between the FCM and DCO,[59] until the position is closed, daily trading gains or losses will increase or decrease the position's open trade equity reflected in the Customer's Account, which will represent the net cumulative (*i.e.*, life-to-date) "unrealized" gain or loss in respect of the position. Unrealized gains and losses will not change the Customer's cash balance, but will increase or decrease open trade equity (and the account's net liquidating equity), and increases in open trade equity resulting from unrealized gains represents "settled cash" that can support new trading.[60] When the position is closed, the cumulative net trading gain or loss reflected in the position's open trade equity will be "realized" and the FCM will credit or debit the cash balance of the Customer Account by the amount of the position's open trade equity (and thereafter no open trade equity will be reflected in respect of the closed position). In addition, when the position is closed, the aggregate initial margin requirement applicable to the Customer Account will be reduced by the amount of initial margin the Customer was required by the FCM to maintain in respect of the position.

Implications of margining practices and regulations in respect of customer entitlements

1.30 To the extent the Customer Account's net liquidating equity exceeds the initial margin requirement for the account, taking into account all open positions, such excess margin amount constitutes "**free funds**" available for withdrawal by the Customer upon its request. When free funds are disbursed to the Customer, the amount of the disbursement is debited from the Customer Account's cash balance (if cash is disbursed) or the non-cash margin balance (if non-cash margin is returned). Because the Customer's entitlement to free funds is determined by reference to its net liquidating equity, the Customer never has a claim against the FCM for payment of trading gains in respect of the Customer's Contracts on a contract-by-contract or gross basis.[61]

Treatment of customer property in the FCM's bankruptcy

1.31 In the event of the FCM's bankruptcy, Customer Funds and customers' open trades and contracts in segregation or otherwise traceable to customers (collectively, "**customer property**") would be subject to the special distribution rules established in the commodity broker liquidation provisions of Subchapter IV of Chapter 7 of the US Bankruptcy Code and the CFTC's Part 190 rules. Prior to the enactment of Subchapter IV in 1978, notwithstanding the requirement to segregate Customer Funds and hold them in an amount sufficient to satisfy all of the FCM's obligations to customers in respect of their net liquidating equities, the special treatment accorded to Customer Funds was not always recognized in the event of an FCM's failure. Although courts addressing FCMs in bankruptcy did accord a preference to customers with respect to Customer Funds held by the FCM in segregation, the theory under which they did so was unclear; they generally did not extend this preference to Customer Funds that were not actually held in segregation; and they often sought to return traceable property – principally securities posted as margin – to the customer that deposited the property, rather than distributing the Customer Funds ratably to all customers, giving that customer a substantially better outcome

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[59] See footnote 20.

[60] For this reason, the daily settlements of variation margin amounts between the DCO and the FCM acting on behalf of its customers in respect of open positions, as discussed in paragraph 1.26, do not result in adjustments of the Customers' cash balances for purposes of margining or segregation; rather, as between the Customer and the FCM, the value to the Customer of its open positions (including the net value of all historic variation margin amounts between the DCO and FCM) is accounted for as open trade equity.

[61] Additionally, the CFTC's Rule 1.56 prohibits the FCM from representing in any way that it will, with respect to any commodity interest carried by the FCM for or on behalf of any person: (1) guarantee such person against loss; (2) limit the loss of such person; or (3) not call for or attempt to collect initial and maintenance margin as established by the rules of the applicable exchange. To the extent a provision in a Customer Agreement entitled the Customer to gross trading gains and such provision was inconsistent with the prohibitions in Rule 1.56, it would be void.

than customers that posted cash as margin.[62] Subchapter IV overcomes these and other concerns by establishing a broad framework for the treatment of customer property in FCM bankruptcy proceedings.

1.32 Subchapter IV provides that customer property is administered in the FCM's bankruptcy as property of the FCM's estate and that customers are treated as creditors, but are granted a statutory preference with respect to all customer property. The FCM's bankruptcy trustee must distribute all customer property of the FCM ratably to the FCM's customers on the basis and to the extent of such customers' allowed net equity claims,[63] and in priority to all other claims (except for certain administrative expenses related to customer property).[64] The high-level framework of Subchapter IV is supplemented by Part 190, which prescribes much more detailed procedures to guide trustees and assist courts in implementing Subchapter IV consistent with the CEA. Part 190 defines "customer property" to include, among other things, customer contracts and property that is properly segregated at the beginning of a Subchapter IV proceeding (*i.e.*, Segregated Funds and Separate Account Funds), but the definition makes clear that the property available for distribution to customers in priority to creditors is not limited to property in actual segregation.[65]

1.33 Part 190 also supplements Subchapter IV's very high-level framework for ratable distribution by specifying that property of the FCM's estate must be allocated among Account Classes (including the US Futures Account Class, the Cleared Swaps Account Class and the Foreign Futures Account Class) and between the FCM's "public" customer class and its "non-public" customer class (*i.e.*, its affiliates and insiders whose accounts are "proprietary"). Each allocated amount is then treated as a separate estate of the Account Class and customer class to which it is allocated. Property segregated for a specific Account Class may only be distributed to customers in that Account Class, and if the customer property for a customer Account Class is insufficient to satisfy the net equity claims of public customers in the Account Class, the shortfall will be shared pro rata by those public customers, and no distribution will be made to non-public customers in the Account Class until those public customers' claims have been satisfied.

1.34 Subchapter IV's requirement that customer property be administered in the FCM's bankruptcy proceedings and its characterization of customer property as property of the FCM's estate and of customers as creditors (rather than owners of the customer property) should not be viewed as inconsistent with the Customer Property Rules and the statutory trusts those rules establish.[66] The statutory preference effectively establishes a

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[62] This last factor was exacerbated by the fact that, at that time, FCMs could accept securities as margin but were not allowed to deposit customer securities as margin with DCOs (due to the CFTC's concern that a DCO would have no way of knowing which Contracts were margined by a particular customer's securities and could not ensure against an unwitting violation on the prohibition of using one customer's assets to secure another customer's liabilities). Thus, securities margin remained at the FCM and was readily traceable and returned to customers, while the cash deposited with the DCO was typically exhausted satisfying variation margin calls in the run-up to the FCM's bankruptcy, leaving little cash available to distribute to the FCM's cash customers.

[63] The Customer's "**net equity**" is "the total claim of the Customer against the estate of the debtor based on commodity Contracts held by the debtor" net of certain amounts and then set out a specific process for calculating net equity. The process requires, among other things, the netting of the Customer's and FCM's obligations to one another that are not in connection with cleared Contracts, with the netted amount deducted from the Customer's net equity; if the Customer has claims in multiple Account Classes, such deduction will be made proportionally. If the Customer has Accounts of more than one class, an amount is determined for each Account Class, and any negative net equity amounts are used to offset any positive equity balance the Customer may have in a different Account Class.

[64] As the CFTC put it, customer property should be treated as a "single and separate fund" in respect of which customers, as a "single and separate class of creditors," would be entitled to share ratably on the basis of their respective net equities.

[65] Customer property also includes property that (1) should have been but was not segregated or as to which segregation was not maintained, (2) was unlawfully converted (by removal from segregation) but remains part of the FCM's estate or (3) was withdrawn from the estate but was subsequently recovered by the trustee's avoidance powers.

[66] A similar recharacterization occurs under the Securities Investor Protection Act ("**SIPA**"), which governs the liquidation of broker-dealers who carry customer accounts. Under SIPA, cash and securities (except customer name securities delivered to a customer) received, acquired, or held by or for the account of a failed broker-dealer from or for the securities accounts of the customer, and the proceeds of any such property, are allocated to customers *pro rata* in accordance with their respective net equities. 15 U.S.C. §§ 78fff-2(c)(1)(B), 78lll(4). This treatment of net equity claims in the bankruptcy of the broker-dealer does not call into question the characterization of the Customer's rights prior to the bankruptcy as a property right under applicable law.

separate bankruptcy estate for each Account Class (which is clearly confirmed in Part 190), or a "single and separate fund" for each Account Class in respect of which customers of that Account Class constitute a "single and separate class of creditors" that shares such property ratably and in priority to claims of the FCM's general creditors. Administering customer property in this manner facilitates a trustee's pursuit of avoidance actions to recover property for distribution to customers[67] and ensures that customer property is subject to Subchapter IV's special distribution scheme, thereby providing a basis for assuring that customers receive priority claims that are coextensive with their ownership interests in property held by the FCM pursuant to the Customer Property Rules and the statutory trusts those rules create.

Implications of Subchapter IV and Part 190 in respect of customer entitlements

1.35 Subchapter IV and Part 190 also allowed the CFTC to modify the Customer Property Rules so that FCMs could deposit customer securities with DCOs as margin because they eliminated the risk that a customer might receive a disproportionate share of the Customer Funds held by the FCM simply because that customer had provided margin in the form of securities. Today, the FCM has significant flexibility to use an individual customer's securities margin. For example, securities deposited with the FCM as margin by the Customer may be deposited by that FCM with a DCO that does not clear the Customer's Transactions (so long as the Customer's Transactions and transactions at the DCO secured by the Customer's securities are in the same Account Class) or the securities may be rehypothecated by the FCM for cash under a repo agreement (provided the FCM maintains such cash in segregation). As a consequence of these changes to the Customer Property Rules, which were possible as a result of the enactment of Subchapter IV and Part 190, each customer in the same Account Class (and the FCM to the extent of its residual interest) can be viewed as having a pro rata claim upon all the assets, whether in the form of cash or securities, rather than in any specific assets, in the Segregated Funds or Separate Account Funds in such Account Class, based on each customer's net liquidating equity.

Customer Collateral

1.36 Under the terms of the Customer Agreement,[68] the Customer typically grants to the FCM a first priority security interest in, lien on and right of set-off against, all the right, title, and interest of the Customer in, to, and under the following property, whether at the time of the grant or thereafter existing (collectively, "**Collateral**"):

(i) the Customer Account, the Contracts carried in or credited to the Customer Account and all rights to payments and deliveries in respect of such Contracts;

(ii) all cash, securities and other property credited to or held in the Customer Account (including any such property that is held by any DCO, foreign clearing organization, Foreign Futures Broker or other person acting for or on behalf of any of the foregoing);

(iii) all other property of the Customer received, acquired or held by or for the FCM or any DCO, foreign clearing organization, Foreign Futures Broker or other person acting for or on behalf of any of the foregoing, or due or deliverable to the FCM or Customer (including amounts due from any DCO, foreign clearing organization, Foreign Futures Broker or other person acting for or on behalf of any of the foregoing), in respect of the Account or the Customer's Contracts; and

(iv) all proceeds of the foregoing.

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[67] The Bankruptcy Code turns to applicable state or other non-insolvency law, in the first instance, to determine whether property is property of the bankruptcy estate and, because property held by the FCM for customers is viewed as property of the customers under the Commodity Exchange Act and applicable state law, it would not be recoverable by the bankruptcy trustee in an ordinary bankruptcy.

[68] Even prior to the adoption of the relevant provisions of the Uniform Commercial Code, FCMs generally were viewed as having a common-law "broker's lien" on their customers' accounts and property credited to those accounts.

1.37 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. The security interest serves the additional purpose in the US of preventing third parties from gaining an intervening interest, or otherwise interfering, in the Customer's Contracts or other property credited to the Customer's accounts.

The Customer Account and Customer Contracts

1.38 Under the Uniform Commercial Code (the "**UCC**"), the Customer's US Futures Account and Foreign Futures Account are categorized as a "commodity account" maintained for the Customer by the FCM as the Customer's "commodity intermediary" and the US Futures and Foreign Futures carried in the Customer Account constitute "commodity contracts." If the FCM and Customer elect to treat the Customer's Cleared Swaps as "financial assets" credited to the Customer's Cleared Swaps Account and they elect to treat the Cleared Swaps Account as a "securities account" maintained for the Customer by the FCM as the Customer's "securities intermediary" (as each of those terms is defined under Article 8 of the UCC), the Customer has "security entitlements" to its Cleared Swaps.[69] Commodity contracts and security entitlements are types of "investment property" and are not "general intangibles" under the UCC.[70] As such, the FCM's security interest in them may be perfected by control, which it has automatically by virtue of its status as commodity intermediary with respect to the Customer's Futures and as securities intermediary with respect to the Customer's Cleared Swaps.[71] If the FCM has control of all security entitlements or commodity contracts carried in a securities account or commodity account, that FCM has control of the securities account and the commodity account and its security interest in each of them is perfected by virtue of such control.

Cash Collateral

1.39 Section X of the S&C Memo discusses different ways by which the FCM may perfect its security interest in the Customer's Collateral consisting of cash (which may represent cash deposited by the Customer with the FCM as margin, as well as cash accruing to the Customer as a result of its Futures or Cleared Swaps). The S&C Memo observes, as an initial matter, that under the common law upon which the FCM-Customer relationship is based, the commingling of Customer Funds on an Account Class basis by the FCM converts the Customer's property interest in its cash margin to a debt claim against the FCM for its repayment of the cash, which may be set off against amounts owed by the Customer to the FCM, including amounts to indemnify or reimburse the FCM for trading losses. Additionally, as a consequence of the Customer Property Rules relating to Permitted Uses and the operation of the three statutory trusts, the FCM generally need not rely upon its security interest in

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[69] Cleared Swaps held through an intermediary are also "securities" within the meaning of the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, July 5, 2006, 46 I.L.M. 649 (the "**Hague Convention**"). This will be true whether or not the FCM and the Customer make a financial asset election. If applicable, the Hague Convention specifies the choice of law to govern certain aspects relating to the attachment and perfection of the security interest. The S&C Memo addresses those matters under New York law.

[70] If, for some reason, the FCM and its Customer did *not* make a financial asset election with respect to Cleared Swaps, then the Cleared Swaps would be "general intangibles" under the UCC.

[71] Under Article 8 of the UCC, the Customer's security entitlement in respect of its Cleared Swaps treated as financial assets constitutes the rights and property interest of the Customer to the Cleared Swaps, which includes a bundle of rights enforceable against the FCM, as the Customer's securities intermediary. A security entitlement is not, however, a specific property interest in any particular Cleared Swap, but rather a pro rata property interest in all interests in that Cleared Swap held by the securities intermediary. While Article 9 of the UCC does not detail the nature of a "commodity contract" in a similar fashion, the rights and interests of the Customer with respect to Contracts carried for it by an agent-trustee are similar, as the Customer has a beneficial interest in the Contracts and in personam rights against the agent-trustee with respect to its handling of the Contracts. In addition, it is consistent with the UCC treatment of a securities account to view the security interest in a commodity account as a security interest in all the property credited to the Customer Account, including its pro rata beneficial interest in the Customer Funds maintained pursuant to the applicable Customer Property Rules, although the commentary to the UCC is not entirely consistent in supporting this conclusion.

order to utilize the Customer's cash to satisfy obligations to DCOs and Foreign Futures Brokers arising in the course of liquidating the Customer Account.

1.40 Nevertheless, it is market practice for the FCM to perfect its security interest in the Customer's Collateral consisting of cash, and there are several methods by which it may do so.

1.40.1 Cash margin delivered to the FCM is initially deposited in a Segregated Account or Separate Account of the FCM maintained with its settlement bank. For purposes of the UCC, given that the cash is subject to immediate withdrawal by the FCM, the Segregated Account or Separate Account constitutes a "deposit account," and the FCM may perfect its security interest in the cash pursuant to the UCC's rules applicable to deposit accounts. Those rules specify that perfection of a security interest in a deposit account is achieved by obtaining control over the deposit account, which the FCM obtains by virtue of the fact the Segregated Account or Separate Account is maintained by the FCM's settlement bank in the name of the FCM. While the FCM's security interest in cash would cease to be perfected when it is transferred from its Segregated Account or Separate Account to a DCO or Foreign Futures Broker unless the FCM's control is maintained, S&C concludes that such control is maintained, and the FCM's security interest in transferred cash remains perfected, because the DCO or Foreign Futures Broker effectively acknowledges it holds an undivided portion of its omnibus account to which the cash is transferred on behalf of the FCM.

1.40.2 By perfecting its security interest in the Customer's US Futures Account or Foreign Futures Account, each of which, as noted above, is a commodity account under the UCC, the FCM should perfect its security interest in all cash balances credited to the Account, without further action.

1.40.3 If the FCM and Customer elect to treat the Customer's Cleared Swaps Account as a "securities account" in respect of which the FCM acts as the Customer's "securities intermediary" and they further elect to treat all cash credited thereto as a "financial asset" (as each such term is defined in Article 8 of the UCC), the FCM's security interest in such cash will be perfected as long as the FCM has control over the Account (as described in paragraph 1.38).

Securities Collateral

1.41 If the Customer delivers margin in the form of securities, the FCM, acting as a "securities intermediary," will credit "security entitlements" to those securities to the Customer's Account (as each of those terms is defined under Article 8 of the UCC). "Security entitlements" are also "financial assets" and "investment property" for purposes of the UCC, and not "general intangibles" under the UCC.[72] As such, the FCM's security interest in them may be perfected by control, which it has automatically by virtue of its status as securities intermediary with respect to the margin in the form of securities.[73]

2 Legal relationships between FCM, Customer and DCO (or Foreign Futures Broker) post-Customer default and the Customer Account liquidation process

2.1 As noted in paragraph 1.11, the FCM holds the Customer's Contracts as agent-trustee under the direction of its principal, the Customer, subject to and in accordance with the Customer Agreement. When the Customer defaults (including upon an insolvency), the FCM is no longer obliged to follow the Customer's instructions[74] 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 Contracts in trust for the Customer and the Customer Funds in accordance with the Customer Property Rules. The FCM may close out or otherwise liquidate the Customer's Contracts and liquidate any related margin or 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, the relevant DCO rules (or the clearing agreement between the FCM and its Foreign Futures Broker) and the common law of agency, to protect itself from the liabilities and losses that it would otherwise suffer as a result of having entered into the Contracts and acted as the Customer's agent. In doing so, the FCM is entitled to prefer its own interest to that of its Customer and to act without seeking Customer consent with respect to the self-protective steps it takes.

2.2 As the FCM holds the Contracts for the benefit of the Customer, the FCM must account to the Customer (as the beneficial owner) for all profits and losses (on a net basis) arising out of the Contracts. As described in paragraphs 1.19 and 1.20, it is also entitled to reimburse itself for any losses or costs incurred or indemnification rights to which it is entitled out of Segregated Funds (or Separate Account Funds) pursuant to the terms of the Customer Agreement and consistent with the terms of the applicable statutory trust, including the provisions of the Customer Property Rules that authorize the FCM to use the Customer Funds held subject to the statutory trust for Permitted Uses.

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72 Securities held through an intermediary are also "securities" within the meaning of the Hague Convention.

73 The terms of a Base Account Agreement typically grant the FCM broad rights to repledge, rehypothecate or dispose of the Customer's Collateral consisting of securities (although such right is subject to "applicable law," including the Customer Property Rules, which require the FCM to segregate or set aside any proceeds from rehypothecating or disposing of the securities). Additionally, the US Futures Customer Property Rules specify that in the daily computing of the amount of US Futures Customer Funds required to be in Segregated Accounts, the FCM may offset any net deficit in the Customer's Account against the current market value of readily marketable securities, less applicable haircuts, held for the Account. However, as a condition to doing so, the FCM must maintain a security interest in the securities "including a written authorization to liquidate the securities at the [FCM's] discretion." As noted in paragraph 1.35, the FCM's rights with respect to the Customer's securities are such that the FCM may deposit the Customer's securities with a DCO that does not clear the Customer's Transactions, so long as the Transactions and the transactions at the DCO secured by the securities are in the same Account Class).

74 The FCM's 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. Furthermore, an agent (including an agent-trustee) may take action to protect itself in the case of its principal's default. The FCM may also be entitled to liquidate the Customer Contracts in some non-default scenarios.

Default and remedial provisions

2.3 The Base Account Agreement contains a section identifying one or more events of default (whether or not described in the agreement as "events of default"), the effect of which is to give the FCM the right to exercise remedies in respect of the Contracts and Customer Funds credited to the Customer Account. In general, those defaults include defaults predicated on (i) the Customer's filing under applicable bankruptcy or similar insolvency laws, (ii) 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 (iii) the appointment of an administrator, conservator, receiver or similar official in respect of the Customer or all or substantially all of its assets (an "**Event of Default**"). The CDA provides that a default, Event of Default or other similar condition or event under the terms of the Base Account Agreement gives the FCM the right to exercise remedies in respect of the Cleared Swaps and Cleared Swaps Customer Funds credited to the Customer Account.

2.4 The Base Account Agreement typically provides that upon the occurrence of an Event of Default, the FCM has the right to, among other things, (1) close out or otherwise liquidate the Customer's open positions in its Contracts, and hedge risk incurred by the FCM in connection with such Event of Default, by any reasonable method, including by means of entering into offsetting transactions, risk-reducing transactions or hedging transactions, and by valuing any transactions entered into by the FCM ("**Position Liquidation**"), (2) treat the Customer's obligations to the FCM to be due and immediately payable and net or set off any obligations of the Customer to the FCM with or against any obligations of the FCM to the Customer and (3) sell, liquidate or otherwise dispose of the Customer's Collateral consisting of securities and other non-cash assets and apply the proceeds therefrom to, or net or set off the value of such proceeds with or against, any amounts due from the Customer to the FCM ("**Margin Liquidation**").[75] The CDA provides the FCM with comparable remedies upon the occurrence of an Event of Default. See the S&C Memo, Section XI.

Position Liquidation and Margin Liquidation

2.5 There are multiple Position Liquidation methods available to the FCM to close out or otherwise liquidate the Customer's open position in a Futures or Cleared Swaps Contract. Each of the methods seeks to "remove" or "close out" the position from the relevant omnibus customer positions account (whether at a DCO or foreign clearing organization). For example, subject to DCO or foreign clearing organization rules and operational feasibility, a FCM may close out an open position by:

> (i) offsetting it with an equal and opposite transaction (an "**offsetting transaction**") executed by or on behalf of the FCM (or by the FCM's Foreign Futures Broker upon the instruction of the FCM), which position may be either (x) directly credited to the FCM's omnibus customer positions account with the DCO (or the Foreign Futures Broker's omnibus customer positions account maintained by the foreign clearing organization) in which the Customer's open position is carried or (y) initially credited to the FCM's house account and subsequently transferred to the FCM's omnibus customer positions account resulting, in either case, upon recordation in the omnibus customer positions account, in cancelation of both the original position and the offsetting transaction; or
>
> (ii) causing the relevant DCO or foreign clearing organization to debit or otherwise remove the position from the FCM's omnibus customer positions account (or the Foreign Futures Broker's omnibus customer positions account maintained by the foreign clearing organization) by book-entry transfer of

[75] As used herein, "Margin Liquidation" refers to sale, liquidation or other disposition of the Customer's securities or other non-cash Collateral other than the Customer's Contracts.

the position to either the FCM's house account or a third party's account, which in either case may be completed as a single position transfer or as part of a transfer of a portfolio of open positions.

2.5.1 In addition to the close-out methods available to the FCM, some of which are described above, the FCM also may enter into (or cause the FCM's Foreign Futures Broker to enter into) one or more transactions in order to hedge or otherwise manage risks it incurs in connection with the liquidation of the Customer Account. These hedging transactions may be executed in either the FCM's omnibus customer positions account or the FCM's house account, or the Foreign Futures Broker's omnibus customer positions account maintained by the foreign clearing organization, in each case, as necessary.

2.5.2 In the case of all close-out and hedging methods, the FCM must determine the related gains and losses realized and make corresponding debits or credits to the cash balance of the Customer's Account. The Position Liquidation method has implications for the determination of gains and losses realized in connection with the close-out, which may or may not correspond to the value of such positions recorded by the applicable DCO or foreign clearing organization.

2.6 In addition to Position Liquidation, the FCM will exercise its Margin Liquidation rights to liquidate the securities and other non-cash assets credited to the Customer Account (to the extent necessary to generate cash proceeds to cover any deficit or debit balance). If the non-cash property has been deposited as margin with a DCO, or has been rehypothecated, then the FCM may either retrieve such property by exercising rights of substitution (or closing open positions) and liquidate it, or determine the value of such property by reference to market prices or in some other commercially reasonable manner and credit the Customer for that value.

Legal characterization of Position Liquidation and Margin Liquidation

2.7 In effecting Position Liquidation, the FCM exercises its contractual rights as principal vis-à-vis the DCO under the relevant DCO rules (or the clearing agreement between the FCM and its Foreign Futures Broker), as permitted under the Customer Agreement. In doing so, the FCM acts as principal in the exercise of its contractual rights under the Customer Agreement (and in accordance with the terms of the applicable DCO rules or clearing agreement with the Foreign Futures Broker), and not as agent of the Customer or pursuant to any power of attorney granted by the Customer. This process is also not a foreclosure, and the FCM need not rely on its security interest in the Customer's Contracts to effect their close-out or liquidation.[76]

2.8 Similarly, in using Customer Funds, including the Customer's securities and other non-cash margin, to satisfy amounts due to the DCO, or to other parties, in the course of liquidating the Customer's Contracts, the FCM is exercising its right, granted under the Customer Property Rules, to "withdraw[] and appl[y]" Customer Funds to "to margin, guarantee, secure, transfer, adjust, or settle the Contracts or trades of such customers, or resulting market positions, with the clearinghouse organization of such contract market or derivatives transaction execution facility or with any member of such contract market or derivatives transaction execution facility." Again, this process is not a foreclosure, and the FCM need not rely on its security interest in the Customer Funds consisting of securities to effect their liquidation or use them in this manner.[77]

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[76] In other words, the FCM, as the contractual counterparty to the DCO (or Foreign Futures Broker) under, and the holder of legal title to, the Customer's Contracts, will exercise contractual rights granted to it by the DCO (or Foreign Futures Broker) to close the Customer's open positions in the Contracts, which will thereby terminate the Customer's beneficial interest in the Contracts. However, as noted in paragraph 1.38, the FCM also has a perfected security interest in the Customer's Contracts and it could elect to exercise its rights as a secured party under the UCC to enforce the security interest and sell, liquidate or otherwise dispose of the Customer's Contracts.

[77] Although the FCM may effect Margin Liquidation pursuant to the authority granted to it under the Customer Property Rules and the Customer Agreement, the FCM may also exercise its rights as a secured party under the UCC, enforce its security interest in the Customer's consisting of securities and other non-cash assets and sell, liquidate or otherwise dispose of that Collateral in a commercially reasonable disposition (UCC § 9-610(a), (b)), and may itself purchase (or "buy in") the Collateral at a public disposition or, if the Collateral

Determination of Account

Calculation of (i) a credit or debit balance in respect of each Account Class within the Customer Account and (ii) an aggregate credit or debit balance in respect of all Account Classes within the Customer Account on a combined basis

2.9 Upon any Position Liquidation, the net cumulative gain (or loss) realized with respect to each position in the Customer's Contracts, and any related payments to or from the Account, will increase (or decrease) the Customer's cash balance. Upon any Margin Liquidation, as the Customer's securities and other non-cash assets are liquidated, or the value of such non-cash assets credited to the Account is determined, the resulting liquidation proceeds or values will also increase the cash balance. The cash balance will also be increased or decreased by other applicable credits and debits, including credits in respect of close-out amounts paid to the FCM's house account and other amounts due to the Customer and debits in respect of amounts payable to the FCM, including Chargeable Costs consisting of reimbursements to the FCM for close-out amounts paid by the FCM with its own funds to third parties and other costs and expenses incurred in connection with the FCM's exercise of remedies.[78]

2.9.1 The FCM will determine a single cash balance based on such debits and credits (the "**Determination of Account**"). A negative cash balance will constitute a debit balance payable by the Customer to the FCM. A positive cash balance will constitute a credit balance payable by the FCM to the Customer.[79] If the Customer's Account includes only one Account Class, then there is a single Determination of Account. If the Customer's Account comprises multiple Account Classes, then there will be a separate Determination of Account for each Account Class and, unless the Customer Agreement provides otherwise, the FCM will aggregate or offset the credit balances or debit balances of all Account Classes to determine a single aggregate credit or debit balance in respect of the Customer Account.

Legal characterization of the Determination of Account

Contractual accounting

2.10 Consistent with the status of the Customer Account as a mutual open account, it is the intent of the FCM and its Customer that the individual debits and credits in the Account represent a connected series of entries of reciprocal charges and allowances that are not to be considered independently but rather as a continuation of a related series generating a running balance, and that upon the liquidation and closing of the Account, the final cash balance in the Account constitute a single indivisible debt claim by one party against the other, as discussed in paragraph 1.6. Accordingly, the FCM's Determination of Account should be viewed as merely an accounting procedure to ascertain what that debt claim is, by calculating the result of applying the debits and credits made to the Customer's Account cash balance, rather than the set-off of independent obligations to bring about a single debt claim. This characterization would apply both to the calculation of the final cash balance for each Account

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is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations, at a private disposition (UCC § 9-610(c)).

78 Any funds received from a DCO or other parties in connection with Position Liquidation or Margin Liquidation must be held in accordance with the Customer Property Rules. As discussed in paragraph 1.19, the Customer Property Rules expressly permit the FCM to withdraw and apply such funds to Permitted Uses, including to guarantee, transfer and settle the Customer's Contracts.

79 Section 7 of the CDA, which covers Events of Default and remedies, sets out how a "net termination amount" would be calculated. However, the events of default and remedies section in a Base Account Agreement will typically not specify how the cash balance is calculated when the Customer's Futures Account is liquidated (because the process for that calculation would presumably be part of the operation of the account inferred from the course of dealing between the parties prior to the Customer's default, industry practice and applicable law, including the margining standards). See paragraphs 1.27 through 1.30.

Class within a Customer Account, and to the calculation of the final cash balance for all the Account Classes on a combined basis.[80]

Enforcement of the FCM's security interest in the Customer's Collateral, netting and set-off

2.11 Alternatively, the FCM could achieve a final Determination of Account pursuant to its right to enforce its security interest in the credits made to the Customer's Account to satisfy the Customer's obligations in respect of the debits made to the Account, or by exercising its rights of setoff or netting, or some combination of these remedies. As noted in paragraph 2.4, all of these are available remedies under the Customer Agreement and the Customer Agreement provides that that these remedies are cumulative and not exclusive and that the FCM is entitled to elect the remedy or remedies it uses.

2.12 As noted in paragraph 1.36, the FCM is granted a security interest in the Customer Collateral, which includes any cash credited to the Account (including the Account's credit balance payable to the Customer). The FCM may enforce that security interest to apply trading gains against trading losses or other Chargeable Costs, to apply the aggregate cash balance in the Customer's Account, or the Accounts relating to the different Account Classes, to amounts owed to the FCM and to apply credit balances against debit balances across Account Classes. See the S&C Memo, Section XI.

2.13 The Determination of Account with respect to the Customer Account could be viewed as involving netting or set-off of the FCM's obligation to account for the net gains on the Customer's Contracts against the Customer's obligations. For example, the realization of cumulative trading gains and losses upon Position Liquidation could be viewed as the determination of the respective obligations of the FCM to pay the trading gains and any other profits derived from its activities on behalf of the Customer under the Customer Agreement against the obligations of the Customer to indemnify the FCM against any trading losses or other costs or losses incurred in carrying out that activity. As discussed in paragraph 1.39, deducting any net cumulative loss realized in Position Liquidation could also be viewed as reflecting a set-off of the FCM's obligation to repay the Customer the cash balance of the Account (which may include net cumulative gains realized in Position Liquidation and proceeds from Margin Liquidation) against the Customer's obligation to pay the FCM an amount equal to any net cumulative losses as well as any Chargeable Costs.

2.14 The combination of the cash balances across Account Classes could also be viewed as contractual set-off. See the S&C Memo, Section XI. Although the Permitted Uses provisions of the Customer Property Rules support set-off within an Account Class, at first blush, they would not appear to provide support for set-off of credit and debit balances of different Account Classes. However, Customer Agreements authorize FCMs to offset these balances against one another. A debit balance in one Account Class may be applied as a Chargeable Cost to another Account Class with a credit balance, thereby reducing the Customer's claim to, and increasing the FCM's residual interest in, the Segregated Funds or Separate Account Funds of the Account Class with the credit balance. In other words, by debiting the Customer's Account for the debit balance of one Account Class,

[80] Stated differently, under this characterization, the Determination of Account is the calculation of a running-account balance of all debits and credits to the Account, which is a determination of the overall value of the single course of dealing between the FCM and the Customer represented by the Account, rather than the set-off of distinct claims arising under separate transactions between the FCM and Customer corresponding, on a back-to-back basis, to the Transactions between a DCO and the FCM (which would be a structural feature characteristic of principal-to-principal model and inconsistent with the nature of the FCM model as a type of agency model). Additionally, the final cash balance of an Account Class calculated in the Determination of Account represents the overall position between the FCM and Customer with respect to the Segregated Funds or Separate Account Funds subject to the statutory trust imposed by the applicable Customer Property Rules, and the balance reflects the results of the FCM's withdrawal and application of the Segregated Funds or Separate Account Funds for Permitted Uses in connection with its Position Liquidation. In applying the Segregated Funds or Separate Account Funds, the FCM is not foreclosing on or enforcing its security interest, or exercising set-off, but rather is acting pursuant to express authority granted it under such Customer Property Rules.

the FCM reduces the Customer's claim against the Segregated Funds or Separate Account Funds for the other Account Class, as described in paragraph 1.19.[81]

The question of mutuality if the Determination of Account involves set-off

2.15 The S&C Memo addresses the question of whether the FCM's obligation to treat Customer Funds (including amounts accruing on any of the Customer's Transaction) as "belonging to" the Customer, or the characterization of the FCM as a "statutory trustee," would prevent the FCM from debiting an insolvent Customer's Account or setting off Customer Funds credited to the Customer's Account (including in respect of trading gains) against the Customer's payment obligations to the FCM (including in respect of trading losses) because they act in different capacities and the obligations of each to the other are not mutual. This question is posed because under New York law, the general rule is that when a creditor's obligations to a debtor arise from a fiduciary duty or in trust, the creditor may not set off those obligations against obligations of the debtor to the creditor. Such a set-off is generally viewed as inconsistent with the fundamental principle that a fiduciary may never deal for its own profit with the subject matter of its trust. An alternative statement of the grounds for prohibiting the set-off is that if the creditor's obligation is in respect of the debtor's property that the creditor holds "without color of lien," then the debtor's claim is a claim to property that cannot be set off against the creditor's debt claim against the debtor. The S&C Memo concludes the FCM's set-off of Customer Funds to or against the Customer's payment obligations to the FCM should not be prohibited for the following reasons:

2.15.1 Any element of trust in the FCM-Customer relationship derives either from the requirements under the Customer Property Rules to segregate or set aside Customer Funds[82] or from the mere fact that the FCM holds title to the customer's property. To the extent that the applicable Customer Property Rules give rise to a statutory trust for the relevant Account Class, that statutory trust is – by its own terms – subject to the FCM's right to use Customer Funds for Permitted Uses. It is, in fact, specifically intended to ensure that funds are available for those uses. Additionally, the duties and rights of an agent, including an agent that holds title to property of its principal, can be varied by agreement, usage and practice, and by other laws and regulations, such as the Customer Property Rules.

2.15.2 Furthermore, the FCM does have a lien or security interest (under both common law and the Customer Agreement) in the Customer Account and any property credited to it. See paragraph 1.36. Under both common law and the Customer Agreement, as well as under the Customer Property Rules, the FCM has the right, when accounting to its Customer, to deduct any advances made from the balance of the account.

2.15.3 Interpreting the fiduciary obligations of the FCM in respect of Customer Funds to preclude the application of Customer Funds for Permitted Uses, or to offset those funds against the Customer's obligations to the FCM for Permitted Uses, would turn the commodities regulatory scheme on its head. In the context of another statutory trust, the Second Circuit Court of Appeals, applying New York law, has held that if a deposit has been made for a particular purpose and would otherwise be available for set-off under applicable state law, a set-off should not be denied on the sole ground that the fund is held under a statutory trust created to protect the depositor's rights in the event no set-off is ever warranted.

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[81] Additionally, it can be argued that the Customer Property Rules permit any excess Customer Funds held in segregation or set aside for one Account Class to be applied to any other Account Class in the context of the Customer's default. In the past several years, the CFTC has emphasized the critical role of CFTC Rule 1.56, which prohibits the FCM from guaranteeing its customers against losses arising from trading, in protecting customers generally from fellow-customer risk, and has described the prohibition on guaranteeing as one of its regulations concerned with the protection of Customer Funds.

[82] In a number of adjudicatory decisions over the years, CFTC staff has stated that the CFTC's view is that upon a futures customer's default, the FCM's duties to the customer under the Customer Property Rules are subject to, and can be superseded by, the FCM's duties to protect the financial position of itself and its other customers through exercising remedies against the defaulter. This view undercuts the argument that set-off is inconsistent with the FCM's duties under the Customer Property Rules.