Linklaters

11 March 2026

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

in respect of (i) the recognition under HKSAR law of (a) New York law as the governing law of the Clearing Agreement and the Agent-Trust arising under the Clearing Agreement and (b) U.S. Federal law as the governing law of certain arrangements relating to Customer Property arising under the Clearing Agreement and (ii) the mandatory principles of HKSAR law that may affect the positions reached under New York law or U.S. Federal law in respect of the operation of the Clearing Agreement, the Agent-Trust and those arrangements.

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I. Introduction

1 Overview

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

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

1.3 The analysis that follows is in four parts.

(i) Section I sets out the scope of this Memorandum and the assumptions to which it is subject;

(ii) Section II sets out our analysis of the U.S. FCM clearing model under HKSAR law by reference to the S&C Memorandum and the summary of the U.S. FCM clearing model provided by the FIA and ISDA set out in Annex 1 of this Memorandum (the "**Summary Annex**");

(iii) Section 7 sets out the questions that we have been asked to address in the instruction letter sent by FIA and ISDA (the "**Instructions**", as set out in Annex 2 of this Memorandum), followed by our responses (which are based on the analysis and conclusions in Section II) and

(iv) Section 4 sets out the qualifications to which this Memorandum is subject.

2 Note on HKSAR law

On 1 July 1997, Hong Kong ("**Hong Kong**") became the Hong Kong Special Administrative Region of the People's Republic of China. On 4 April 1990, the National People's Congress (the "**NPC**") of the PRC adopted the Basic Law of the HKSAR (the "**Basic Law**"). Under Article 8 of the Basic Law, the laws of Hong Kong in force at 30 June 1997 (that is, the common law, rules of equity, ordinances, subordinate legislation and customary law) are to be maintained, except for any that contravene the Basic Law, and subject to any amendment by the legislature of the HKSAR. Under Article 160 of the Basic Law, the laws of Hong Kong in force at 30 June 1997 are adopted as laws of the HKSAR except for those which are declared by the Standing Committee of the NPC (the "**Standing Committee**") to be in contravention of the Basic Law. If any laws are later discovered to be in contravention of the Basic Law, they shall be amended or

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

cease to have force in accordance with the procedure prescribed by the Basic Law.[2] Thus we have assumed in giving this Memorandum that the common law and rules of equity of England which applied in Hong Kong on 30 June 1997 continue to apply, subject to:

(i) their subsequent independent development, which rests primarily with the courts of the HKSAR;

(ii) the extent to which they contravene the Basic Law of the HKSAR; and

(iii) their amendment by the HKSAR legislature.

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

3 Interpretation

3.1 In this Memorandum:

(a) "**Account Class**" has the meaning given to the term "account class" in the Summary Annex;

(b) "**Agent-Trust**" means the capacity in which an FCM holds the Customer Transactions for the benefit of the Customer as a result of its agency relationship with the Customer, as described in the S&C Memorandum and as summarized in the Summary Annex;

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

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

(e) "**BAO**" means the Banking Ordinance (Cap. 155);

(f) "**BO**" means the Bankruptcy Ordinance (Cap. 6);

(g) "**Cash Arrangement**" has the meaning given to it in paragraph 1.4.2(iii) of Section II of this Memorandum;

(h) "**Cash Entitlement**" has the meaning given to it in paragraph 1.4.2(iv) of Section II of this Memorandum;

(i) "**CDA**" means an addendum for Cleared Derivatives Transactions in the form published by FIA and ISDA in 2012 or 2018;

(j) "**Chargeable Costs**" has the meaning given to the term "chargeable costs" in the Summary Annex;

(k) **"Cleared Swaps**" has the meaning given to the term "cleared swaps" in the Summary Annex;

[2] The HKSAR Court of Appeal in the case of *HKSAR v Ma Wai-kwan and others* [1997] 2 HKC 315 as approved and applied by the HKSAR Court of First Instance in the case of *Re Sui See Chun, ex parte The Bar Council* [1998] 343 HKCU 1.

(l) "**Clearing Agreement**" means the documentation entered into between a Customer and the FCM that generally consists of:

(i) (A) a customer account agreement governed by the law of the State of New York (a "Base Account Agreement"), if the Customer is trading only Futures, or (B) a Base Account Agreement with a CDA, if the Customer is trading only Cleared Swaps or both Futures and Cleared Swaps; and;

(i) One or more other documents relating to the terms of the relationship between the FCM and the Customer in relation to Customer Transactions each governed by the law of the State of New York;

(ii) in each case including any DCO rules (or clearing house agreement between the FCM and its Foreign Futures Broker) that it is subject to;

(m) "**CO**" means the Companies Ordinance (Cap. 622);

(n) "**CPO**" means the Conveyancing and Property Ordinance (Cap. 219);

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

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

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

(r) "**Customer Property Rules**" has the meaning given to it in the Summary Annex;

(s) "**Customer Transaction**" means , in respect of a Customer, a Future and/or a Cleared Swap, entered into by the FCM on behalf of such Customer pursuant to a Clearing Agreement;

(t) "**C(WUMP)O**" means the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32);

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

(v) "**Determination of Account**" has the meaning given to it in the Summary Annex;

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

(x) ""**Foreign Futures**" has the meaning given to the term "foreign futures" in the Summary Annex;

(y) "**Foreign Futures Broker**" has the meaning given to the term "foreign futures broker" in the Summary Annex;

(z) "**Futures**" has the meaning given to the term "futures" in the Summary Annex;

(aa) "**HKSAR Bank**" means a bank, if incorporated or otherwise organized in the HKSAR under the CO, having its head office in the HKSAR and an authorized institution under the BAO;

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

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

(dd) "**Liquidation**" means either or both of a Position Liquidation and a Margin Liquidation;

(ee) "**Margin Liquidation**" has the meaning given to it in the Summary Annex;

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

(gg) '**Offsetting Transaction**" has the meaning given to the term "offsetting transaction" in the Summary Annex;

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

(ii) "**Position Liquidation**" has the meaning given to it in the Summary Annex;

(jj) "**Proprietary Uses**" has the meaning given to it in paragraph 3.8.6(ii)(c) of Section II of this Memorandum;

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

(ll) "**Resolution Ordinance**" means the Financial Institutions (Resolution) Ordinance (Cap. 628);

(mm) "**RTO**" means the Recognition of Trusts Ordinance (Cap. 76);

(nn) "**Securities Arrangement**" has the meaning given to it in paragraph 1.4.2(ii) of Section II of this Memorandum;

(oo) "**Security Interest**" means the New York law governed security interest granted by the Customer to the FCM over; (i) the Customer's proprietary interests in the Collateral; and (ii) the contractual rights that the Customer has in respect of the Collateral;

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

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

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

(ss) "**Separate Account Funds**" has the meaning given to the term "separate funds account" in the Summary Annex;

(tt) "**SFO**" means the Securities and Futures Ordinance (Cap. 571);

(uu) "**Statutory Arrangement**" means the separate statutory arrangements (that, as described in paragraph 1.4.2 of Section II, may or may not constitute trusts as a matter of U.S. Federal or state law) established over all the Statutory Property held by the FCM for the benefit of its customers in each applicable Account Class (and to the extent of the Residual Interest, the FCM) as described in the S&C Memorandum and Summary Annex ('**Statutory Arrangement**" may refer, as the context requires, to any Statutory Arrangement relating to the FCM or all Statutory Arrangements relating to the FCM on a combined basis);

(vv) "**Statutory Property**" means the Segregated Funds and/or Separate Account Funds (as applicable) held by the FCM on the terms of the Statutory Arrangement(s);

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

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

(yy) "**Transaction**" means any of the following transactions entered into pursuant to a Clearing Agreement; Customer Transactions, Offsetting Transactions; risk-reducing transactions, hedging transactions and any transaction entered into to effect a Position Liquidation (if any)[3];

(zz) "**Trust Property**" means either or both of the Agent-Trust Property or the Statutory Property, as applicable;

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

(bbb) "**U.S. Trust**" has the meaning given to it in paragraph 1.4.2(i) of Section II of this Memorandum;

(ccc) "**U.S. Trust Beneficial Interest**" means a Customer's beneficial interest in U.S. Trust Property;

(ddd) "**U.S. Trust Property**" means the Statutory Property when it is held under a Statutory Arrangement that is a U.S. Trust;

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

(fff) "**US Futures**" has the meaning given to the term "US futures" in the Summary Annex.

3.2 In this Memorandum, references to the commencement of insolvency proceedings refers to the presentation of a petition for winding-up (that is, after the presentation of a petition for a winding-

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

up order or the passing of a resolution for a voluntary winding up (section 184 of the C(WUMP)O).

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

4 Scope of Customer types covered by this Memorandum

In this Memorandum we consider the issues that you have asked us to address only in respect of a Corporation, if incorporated as a company in the HKSAR under the CO (an "**HKSAR Company**"), and including, without limitation:

(i) a Bank/Credit Institution, if incorporated as an HKSAR Company, having its head office in the HKSAR and an authorized institution under the BAO; and

(ii) an Investment Firm/Broker Dealer, if incorporated in the HKSAR under the CO.

We do not consider any other type of entity.

5 Scope of material reviewed

For the purposes of this Memorandum, we have read the memorandum prepared by Sullivan & Cromwell LLP entitled "*Memorandum to the Futures Industry Association and the International Swaps and Derivatives Association, Inc. Regarding Futures and Options Transactions, Cleared Swaps and Foreign Futures Transactions Executed and Carried by Futures Commission Merchants for their Customers*" dated 17 November 2021 (the "**S&C Memorandum**") and the supplementary summary of the U.S. clearing model set out in the Summary Annex (the "**U.S. Clearing Model**") and assume the following:

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

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

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

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

For the avoidance of doubt, for the purposes of this Memorandum, we have only relied on explanations of the terms of certain underlying documents, as well as the summary of the U.S. Clearing Model set out in the Summary Annex, the S&C Memorandum and the Instructions and

we have not reviewed any other documents. In certain parts of this Memorandum, we have been asked to assume certain matters that are not apparent from the Summary Annex, the S&C Memorandum or the Instructions. Where this is the case, we have noted this in a footnote. We rely on the contents of the Summary Annex, the S&C Memorandum and the Instructions without any further checks for the purposes of providing this Memorandum. Any reference to "our understanding" or "we understand" in this Memorandum should be construed accordingly. Our analysis is limited to the issues specifically addressed in this Memorandum.

6 Assumptions

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

6.1 The Clearing Agreement, applicable DCO rules (or the clearing agreement between the FCM and its Foreign Futures Broker) and the Transactions entered into thereunder constitute legal, valid, binding and enforceable obligations as regards the relevant DCO (or Foreign Futures Broker), FCM and the Customer who are party to them under New York law (or the law governing the clearing agreement between the FCM and its Foreign Futures Broker).

6.2 The applicable DCO rules (or the clearing agreement between the FCM and its Foreign Futures Broker) permit the FCM to effect a Position Liquidation and a Margin Liquidation and to enter into Offsetting Transactions, risk-reducing transactions, hedging transactions or any other transaction in order to effect a Position Liquidation (if any) following a Customer default, as set out in the Summary Annex.

6.3 Each of the FCM and the Customer has obtained all licences, approvals, authorisations and consents under all applicable laws which may be necessary in connection with the Clearing Agreement and any Transaction or arrangement entered into thereunder and is in compliance with all applicable laws in connection with the Clearing Agreement and any Transaction or arrangement entered into thereunder.

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

6.5 The Clearing Agreement and all Transactions and arrangements thereunder have been or will be entered into for *bona fide* commercial reasons, on arm's length commercial terms by the parties so that no element of gift or undervalue from the insolvent party to the other party is involved and without any intention of the insolvent party to prefer the other party and the Clearing Agreement correctly reflects the terms agreed between the parties. In addition, we assume that

the Clearing Agreement only documents the arrangements described in the S&C Memorandum (and nothing else), does not require grossly exorbitant payments, does not otherwise grossly contravene ordinary principles of fair dealing and does not include any provision that would adversely affect the conclusions in this Memorandum.

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

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

6.8 Each Customer Transaction, Offsetting Transaction, risk-reducing transaction, hedging transaction and/or any transaction entered into in order to effect a Position Liquidation (if any) will be in accordance with the Clearing Agreement and the applicable DCO rules (or the clearing agreement between the FCM and its Foreign Futures Broker) and none of the provisions of any Transactions will affect the conclusions set out in this Memorandum.

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

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

6.11 Customer Transactions and Statutory Property do not form part of the FCM's general estate on insolvency.

6.12 In conducting a Liquidation, the FCM will only withdraw amounts from the Statutory Property for Permitted Uses or Proprietary Uses.

6.13 Under U.S. Federal law, a separate Statutory Arrangement is established over the Statutory Property held by the FCM for the benefit of its customers for each Account Class. As a result, there could be three separate Statutory Arrangements arising under the Clearing Agreement.

6.14 Although the Security Interest may also secure liabilities of the Customer to the FCM other than under the Clearing Agreement,[4] such other liabilities will not be included in the liquidation process after the default of a Customer.

6.15 The U.S. security arrangement meets the requirements under the UCC in order to, and does, create a specific security interest in the Customer's rights and interest in its Collateral.

6.16 New York law and U.S. Federal law provide that the Agent-Trust Beneficial Interest and a U.S. Trust Beneficial Interest are each not an interest in any specific asset that constitutes the Agent-Trust Property or the U.S. Trust Property (as applicable) but rather is are:

(i) in respect of an Agent-Trust Beneficial Interest, a beneficial interest in the Agent-Trust Property as a whole or multiple *pro rata* beneficial interests in only subsets of the Agent-Trust Property reflecting the Customer Transactions cleared by the FCM for that Customer; and

(ii) in respect of a U.S. Trust Beneficial Interest, a beneficial interest in the U.S. Trust Property as a whole or multiple beneficial interests in sub-pools or classes of assets included in the U.S. Trust Property.[5]

[4] See paragraph 1.38 of the Summary Annex.

[5] See paragraph 1.11 of the Summary Annex and paragraphs 1.4.1 and 1.4.2(i) of Section II of this Memorandum.

II. Analysis of the U.S. Clearing Model under HKSAR law

1 Introduction

1.1 In this Section II we set out our analysis with respect to:

(i) the law governing the contractual aspects of the Clearing Agreement;

(ii) the recognition under HKSAR law (either statute or common law) of the Agent-Trust and the U.S. Trust and the risk of characterisation of either arrangement as a security interest;

(iii) the mandatory HKSAR insolvency principles that come into play following the commencement of insolvency proceedings in respect of a Customer and their interaction with the U.S. Clearing Model;

(iv) the law that determine the effectiveness of the Security Interest; and

(v) analysis of various pre- and post-insolvency aspects of the Security Interest, including as to withdrawals for Permitted Uses and Proprietary Uses.

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

(i) a contractual provision; or

(ii) a term of a trust.[6]

We analyse either scenario below.

1.3 We also examine each of the three elements of the U.S. Clearing Model in turn:

(i) the contractual provisions relating to aspects of the FCM/Customer relationship;

(ii) the Agent-Trust and, if the Statutory Arrangement(s) are recognised as a valid trust under U.S. Federal or state law, the Statutory Arrangement(s); and

(iii) the Security Interest.

1.4 Our analysis in relation to the Agent-Trust and Statutory Arrangement(s) depends on the nature of the Customer's interest in the Agent-Trust Property and Statutory Property (as applicable):

The Agent-Trust

1.4.1 With respect to the Agent-Trust, we understand that, although it is clear that the Customer does not have a beneficial interest in individual or specific Customer Transactions cleared for it by the FCM, it is unclear whether the Customer either (i) has a beneficial interest in the Agent-Trust Property as a whole (i.e. the Customer's beneficial interest in the Agent-Trust Property is an interest in a proportionate share of all assets

[6] To the extent that a particular provision of the Clearing Agreement gives rise to a Statutory Arrangement that is not recognised as a valid trust under U.S. Federal or state law, the conflicts of laws analysis in this Memorandum is limited to considering the circumstances in which HKSAR law would consider applicable U.S. law to be the applicable law(s) to determine the effect of the creation of a security interest in the Customer's interest in the Collateral.

constituting the Agent-Trust Property held by the FCM for all its Customers in an Account Class); or (ii) the Customer has multiple *pro rata* beneficial interests in only subsets of the Agent-Trust Property reflecting the Customer Transactions cleared by the FCM for that Customer (and its other customers with open positions in such Transactions). As relatively little turns on this in the remainder of this Memorandum, we make limited references to this distinction going forward.

The Statutory Arrangement(s) including the U.S. Trust.

1.4.2 With respect to the Statutory Arrangement(s), whilst we understand that it is most likely that the Statutory Arrangement(s) will be recognised as a valid trust under U.S. Federal or state law (i.e. the scenario in sub-paragraph (i) below), for completeness, we consider each of the below types of Statutory Arrangement, including where the Statutory Arrangement(s) is/are not be recognised as a valid trust under U.S. Federal or state law (i.e. the scenario in sub-paragraphs (ii) – (iv) below):[7]

(i) There is a Statutory Arrangement that is recognised as a valid trust under U.S. Federal or state law. The Customer has no direct property interest in specific securities and/or a specific amount of cash comprising the Statutory Property, but, instead, the Customer has either an undivided interest in the entire pool of securities and/or total amount of cash (as applicable) or multiple undivided interests in sub-pools or classes of assets, in each case held on trust *pro rata* to its entitlement. We refer to such a Statutory Arrangement as a "**U.S. Trust**".[8] The

[7] There is relatively little guidance in the S&C Memorandum and the Summary Annex on the nature of Statutory Arrangements that may not be recognised as a valid trust under U.S. Federal or state law. For the purposes of this Memorandum, we note three different types of Statutory Arrangement that may not be recognised as a valid trust under U.S. Federal or state law, as described in sub-paragraphs (ii) to (iv) of this paragraph 1.4.2.

[8] On account of the uncertainty as to whether or not the Customer's interest in Statutory Property is in the nature of a single interest in the Statutory Property as a whole or comprises multiple interests in sub-pools or classes of assets included in the Statutory Property, this Memorandum has been written on the understanding that the Customer's interest in Statutory Property may, at any time, comprise either type of arrangement.

This approach is, in our view, supported by the discussion in paragraphs 1.32 to 1.36 of the Summary Annex, which highlights different judicial approaches taken prior to the enactment of Subchapter IV to a customer's ability to assert proprietary rights over Customer Property in an FCM's insolvency, which is the scenario in which the ability to assert a proprietary right is most relevant. We understand that Subchapter IV (which is primary legislation in the US) and Part 190 (which are rules promulgated by the CFTC under authority conferred on it by Congress) effectively provide for the *pro rata* distribution of Customer Property upon the bankruptcy of an FCM by reference to each Customer's Net Liquidating Equity on an Account Class by Account Class basis (see paragraph 1.33 of the Summary Annex for more detail). In this respect, we note that, following the bankruptcy of an FCM, a Customer is entitled to share rateably in all Customer Property held by the FCM, but also that a Customer that is identified as having a claim to specifically identifiable property is entitled to have its *pro rata* claim first satisfied out of that Customer's specifically identifiable property (see paragraphs 1.34.1 to 1.34.3 of the Summary Annex). We understand that there is no definitive legal authority in the U.S. as to whether a Customer's claim in respect of its specifically identifiable property is a proprietary one (albeit limited to the value of its Net Liquidating Equity and so not conferring a proprietary entitlement to specifically identifiable property in excess of the value of its Net Liquidating Equity (and we note that a Customer that wishes to recover its specifically identifiable property in excess of the value of its Net Liquidating Equity must pay that excess value into the bankruptcy estate - see paragraph 1.34.1 of the Summary Annex)) or a procedural one, whereby the FCM's bankruptcy trustee is mandated to distribute the Customer Property held by the FCM in a particular manner without affording the Customer a proprietary interest in its specifically identifiable property. We also understand that, as Subchapter IV and Part 190 are derived from US bankruptcy legislation, they may not affect the characterisation of a Customer's proprietary interest before an FCM's bankruptcy, as the U.S. bankruptcy legislation only governs following the bankruptcy of the FCM and so is not dispositive of the legal relationship created by the Clearing Agreement before an FCM's bankruptcy. "Subchapter IV", "Part 190" and "specifically identifiable property" are not defined in the Summary Annex, however, the context of their use makes their meaning clear. For purposes of this footnote, references to those terms are to those terms as they are used in the Summary Annex.

Customer may also have a "security entitlement" under Article 8 of the UCC (or similar rights under U.S. Federal or state law) in the securities under such Statutory Arrangement.

(ii) The Customer has a "security entitlement" under Article 8 of the UCC (or similar rights under U.S. Federal or state law) in the securities transferred by the Customer to the FCM but the Statutory Arrangement relating to such securities is not recognised as a valid trust under U.S. Federal or state law. We refer to such a Statutory Arrangement as a "**Securities Arrangement**".

(iii) With respect to cash transferred by the Customer to the FCM where (a) the Statutory Arrangement relating to such cash is not recognised as a valid trust under U.S. Federal or state law, and (b) the Customer does not have a direct interest in the underlying bank account in which such cash is deposited. We refer to such a Statutory Arrangement as a "**Cash Arrangement**".

(iv) With respect to cash transferred by the Customer to the FCM where (a) the Statutory Arrangement relating to such cash is not recognised as a valid trust under U.S. Federal or state law, and (b) the Customer does have a direct interest in the underlying bank account in which such cash is deposited. We refer to such a Statutory Arrangement as a "**Cash Entitlement**".

The relationship between Statutory Property and Customer Funds

1.4.3 We note that the Customer's entitlement to Statutory Property is determined by reference to its "Net Liquidating Equity" (see paragraphs 1.6, 1.7 and 1.28 to 1.31 of the Summary Annex and footnote 7) and that when an FCM withdraws Statutory Property from its segregated or separate accounts for "Permitted Uses", including repledges to DCOs or foreign futures brokers, or to make permitted investments (see footnote 46 of the Summary Annex), it is entitled to withdraw Statutory Property in respect of the Account Class (as opposed to Statutory Property corresponding to a particular Customer) (see paragraph 1.36 of the Summary Annex). Thus, a Customer may not have a contractual or proprietary entitlement to all its Customer Funds credited to its customer account (as its entitlement is limited to its Net Liquidating Equity) and, in addition to assets delivered by Customers and the FCM (by contribution to its Residual Interest and the investment of Customer Funds in permitted investments), Statutory Property (which may comprise different assets to the assets originally delivered by Customers) may be delivered into segregation by DCOs or Foreign Futures Brokers.[9] Therefore, whilst an FCM is required

[9] For example, if a Customer A deposits Customer Funds comprising 500 units of a security having ISIN XYZ, then Customer A will have Customer Funds credited to Customer A's customer account reflecting those securities. If the FCM then applies 200 of those securities in Permitted Uses for a different Customer of the same Account Class that has not posted those securities, which we understand is permissible (and assuming that no other Customer has posted those securities with that ISIN), then Customer A will have a Customer Funds balance that represents a contractual entitlement to that balance, but because there will only remain 300 securities, Customer A cannot have a proprietary interest in 500 securities because they are not held by or to the order of the FCM. If, on the other hand, the FCM does not apply those securities in Permitted Uses, but Customer A has unrealised losses on its Customer Transactions, that will result in Customer A's Net Liquidating Equity being less than the value of its Customer Funds. In such a case, we understand that Customer A will have neither a contractual claim for the full value of its Customer Funds nor a proprietary claim to the full value of its Customer Funds, as, in each case, the claim would be limited to its Net Liquidating Equity.

to segregate Customer Funds (see paragraph 1.12 of the Summary Annex), there may very well be an imbalance between the Customer Funds of each Customer as recorded by the FCM in its books and records and the Statutory Property held in segregation. Assuming that the FCM complies with the segregation requirements of the Customer Property Rules (including by maintaining an adequate Residual Interest and segregating permitted investments of Customer Funds), whilst there will always be Statutory Property of sufficient value to meet the requirement to segregate Customer Funds, there will not be a direct correlation between the Statutory Property so held and the Customer Funds so recorded due to the imbalances referred to above.

The relationship between Statutory Property and Collateral

1.4.4 Following on from paragraph 1.4.3 of this Section II, we also note that the Collateral (even excluding for the purpose of this paragraph 1.4.4 the Customer Transactions, which do not comprise Statutory Property but, rather, comprise the Agent-Trust Property) described in paragraph 1.37 of the Summary Annex may be different to the Statutory Property, in each case in respect of all Customers of the same Account Class. Specifically, we understand that the Security Interest is not expressed to be granted over the Customer's rights and interest in (or entitlement to) the Statutory Property but, rather, the Customer's rights and interest in the Collateral (which are generally limited to assets delivered to the FCM by the Customer and certain proceeds of such assets, all as recorded in the Customer Account, such that assets not recorded in the Customer Account are unlikely to be Collateral for the applicable Customer, even if they comprise Statutory Property). In connection with this, we understand that, if the Statutory Arrangement comprises a U.S. Trust, the Security Interest will not extend to the Customer's U.S. Trust Beneficial Interest, as the Statutory Property may include assets that are not Collateral (for example, assets deposited into segregation by the FCM as its residual interest) whilst the Security Interest will be limited to the Customer's rights in respect of the Collateral. Likewise, if the Statutory Arrangement does not comprise a U.S. Trust, the Security Interest will still be limited to the Customer's rights and interest in the Collateral, which is likely to be different from the Customer's interest in the Statutory Property. A consideration of the nature of the Customer's rights and interest in the Collateral is outside the scope of this Memorandum. We have assumed in paragraph 6.16 of Section I that the Clearing Agreement is effective in order to, and does, create a specific security interest in the Customer's rights and interest in its Collateral in favour of the FCM as a matter of New York law.

2 Contractual aspects of the U.S Clearing Model under HKSAR law

Summary:

- As far as HKSAR law is concerned, the law governing the contractual aspects of the U.S. Clearing Model is the governing law chosen by the parties. In the case of the U.S. Clearing Model, this would be New York law, being the chosen governing law of the Clearing Agreement.
- We consider the exceptions to this principle: none of these appear to apply.

2.1 Conflict of laws analysis

2.1.1 So far as HKSAR law is concerned, the law governing the contractual aspects of an arrangement is, subject to certain exceptions (which are discussed below), the governing law chosen by the parties.

2.1.2 Therefore, if proceedings were brought before an HKSAR court in respect of the Clearing Agreement and New York law is pleaded and proved as a fact in accordance with HKSAR procedural and evidential rules, the choice of New York law as the governing law of the Clearing Agreement would be recognised by the HKSAR court and, accordingly, New York law would govern the validity, binding effect and enforceability of the Clearing Agreement. This general principle is subject to the following exceptions:

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

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

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

(iv) the HKSAR courts may not be restricted from applying overriding mandatory provisions of HKSAR law;

(v) if there is a provision of New York law that is manifestly incompatible with HKSAR public policy, it is possible that the HKSAR courts may not apply it; and

(vi) the effectiveness of the choice of New York law as the governing law of the Clearing Agreement will be subject to the requirement that such choice of law must be made in good faith, is “bona fide and legal” (i.e. legal under the laws of the other relevant jurisdiction) and is not intended to evade the provisions of another legal system with which the Clearing Agreement has a closer connection.

2.1.3 The above requirements are intended to prevent parties from agreeing to a choice of law in order to evade the consequences of the law which should “properly” have governed the contract – this might apply where parties pick a foreign law purely for the purpose of trying to avoid some local tax liability.

2.2 Application to the contractual provisions of the Clearing Agreement

2.2.1 We must therefore consider whether the contractual provisions of the Clearing Agreement come within the scope of the exceptions set out in paragraph 2.1.2 of this Section II.

2.2.2 The exceptions described in paragraphs 2.1.2(i), (ii), (iii) and (vi) of this Section II above are questions of fact. In respect of paragraphs 2.1.2(i) and (iii), we assume that the performance of the obligations under the Clearing Agreement will occur in the U.S. or in the HKSAR and that there are no overriding provisions of U.S. Federal or state laws that would make the performance of the contract unlawful. Relevant overriding provisions of HKSAR law are discussed further below. We also assume, given the location of the FCM in the U.S. that the exceptions referred to in paragraph 2.1.2(ii) will not apply.

2.2.3 In respect of the exception described in paragraph 2.1.2(v) above, we do not believe that the contractual provisions of the Clearing Agreement described in the S&C Memorandum and the Summary Annex would be manifestly incompatible with HKSAR public policy.

2.2.4 In respect of the exception described in paragraph 2.1.2(iv) above, it is necessary to consider whether application of all or any of the contractual provisions constitute a penalty as a matter of HKSAR law.

2.2.5 In the HKSAR Court of Final Appeal case of *Bank of China (Hong Kong) Ltd v Eddy Technology Co Ltd & Ors*[10] and the HKSAR Court of First Instance case of *Re Hsin Chong Construction Co Ltd*[11], the court affirmed and applied the rule established in *Cavendish Square Holding BV v Talal El Makdessi*[12] which stated that the test for determining whether or not a provision constitutes a penalty is whether it is "a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation". There are therefore three elements to this test. The first is that a provision will only be a penalty if it is a secondary, rather than a primary, obligation. The second is that, even if a provision is a secondary obligation, it will only be a penalty if it bears no relation to the legitimate interests of the innocent party. The third is that, having regard to the identified legitimate interest, the secondary obligation must be exorbitant or unconscionable in amount or in its effect. In the case of a negotiated contract between properly advised parties of comparable bargaining power, there will be a strong initial presumption that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach. In this regard, we do not believe that the contractual provisions of the Clearing Agreement described in the S&C Memorandum and the Summary Annex would constitute a penalty but would note that we have not reviewed any specific Clearing Agreement for the purpose of this Memorandum.

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

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[10] [2019] 5 HKC 496.

[11] [2020] HKC 151.

[12] [2015] UKSC 67. Confirmed in *Houssein & Ors v London Credit Ltd & Anor [2024] EWCA Civ 721.*

2.2.7 Therefore, we consider that, subject to the discussion in paragraph 4 of this Section II, none of the exceptions in paragraph 2.1.2 of this Section II apply and so New York law would be recognised as the governing law of the contractual aspects of the US Clearing Model.

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

Summary:

- In this section, we analyse each of the Agent-Trust and U.S. Trust. If either the Agent-Trust or the U.S. Statutory Trust falls within the RTO, the governing law of the trust determines the characterisation and validity of the trust. This will be a matter of New York or U.S. Federal law respectively and we understand that in either case a valid trust exists under such laws.
- The Agent-Trust is likely to fall within the RTO. However, there is doubt as to whether the U.S. Statutory Trust falls within the RTO. If this is the case, the characterisation of the U.S. Trust will be a matter of HKSAR common law conflicts of law regarding trusts. The analysis will point to the validity of the trust being a matter of New York or U.S. Federal law respectively and we understand that in either case a valid trust exists under such laws.
- Neither of the Agent-Trust and U.S. Trust is likely to be recharacterized as a security interest.
- Additionally we understand that the fact that the FCM is permitted to withdraw funds for certain Permitted Uses and Proprietary Uses is unlikely to change this conclusion.

3.1 Validity of trusts under HKSAR law

3.1.1 We understand that the relationship between the parties gives rise to an Agent-Trust and a U.S. Trust, being a Statutory Arrangement recognised as a trust under U.S. Federal or State law. The first issue we have to consider is HKSAR conflicts of law principles regarding trusts and which laws govern the validity of the Agent-Trust and the U.S. Trust a. We will analyse this under two scenarios:

(a) where the RTO, which (with some omissions and extensions) implements the Hague Convention on the Law Applicable to Trusts and on Their Recognition (the "Convention") to those trusts which fall within its scope, applies; and

(b) where the common law principles governing trust arrangements outside the scope of the RTO, apply.

3.2 Validity of trusts within the scope of the RTO

3.2.1 For a trust that falls within the RTO, the validity of the trust will be determined by the law determined by the RTO as being the governing law of the trust.

3.2.2 The first question is whether the trust falls within the scope of the RTO. A trust will fall within the scope of the RTO if it comes within the following definition of a "trust" set out in Article 2 of the Schedule to the RTO if:

> *"The legal relationship created inter vivos or on death by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.*
>
> *A trust has the following characteristics—*
>
> *(i) the assets constitute a separate fund and are not a part of the trustee's own estate;*
>
> *(ii) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;*
>
> *(iii) the trustee has the power and the duty, in respect of which it is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon it by law.*
>
> *The reservation by the settlor of certain rights and powers, and the fact that the trustee may itself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust."*[13]

3.2.3 In addition, the RTO applies only to trusts as defined in the RTO if they are created voluntarily and evidenced in writing.[14] In particular, there is some doubt as to whether trusts that arise by operation of statute are "created voluntarily".[15] We note that the scope of the Convention was extended by the RTO in the HKSAR to "other trusts or property arising under the law of the HKSAR or by virtue of a judicial decision, whether in the HKSAR or elsewhere".[16] However, trusts that arise under a foreign law do not derive the benefit of this extension.

Determination of the governing law of trusts within the scope of the RTO

3.2.4 If the RTO applies to a trust, then the rules of the RTO apply to determine its governing law. The RTO codifies a set of rules for identifying the governing law of a trust: the express or implied choice of the settlor takes priority and the settlor's choice is

[13] Article 2 in the Schedule to the RTO. This is broadly in line with the characteristics of a trust under the common law.

[14] Article 3 of the Schedule to the RTO. "Evidenced in writing" does not strictly require the execution of a formal declaration of trust. While it is recognised that trusts may be established orally or by simple delivery of the goods to the trustee, paragraph 52 of the *Explanatory Report on the 1985 Hague Convention* by Prof von Overbeck (the "**Explanatory Report to the Hague Convention**") explains that it is reasonable to at least require evidence in writing that expresses the intentions of the settlor.

[15] The Explanatory Report to the Hague Convention (paragraph 49) asserts that that trusts "created of operation of law or by judicial decision" are excluded from the Hague Convention though other commentators have a different view.

[16] This provision appears to be ultra vires the Convention, which in Article 20 (that underlies the enactment of section 2(3)) permits the scope of the Convention to be extended to judicial decisions only. We do not think it is necessary to consider this aspect further in this Memorandum as the extension clearly does not apply in the context of the U.S. Trust which does not arise under HKSAR law.

unfettered. If there is no express or implied choice, the governing law is found by applying a series of tests designed to establish the law of the closest connection. [17]

Implications of the choice of governing law

3.2.5 Article 8[18] of the Schedule to the RTO deals with the governing effects of the chosen law. In particular, the chosen law governs the validity of the trust, its construction, its effects and the administration of the trust. It covers relationships between the trustee and the beneficiaries and the extent of all duties owed by the trustee to the beneficiaries, including the duty of care.[19]

3.2.6 The general scope of Article 11 is subject to Article 15 (which sets out certain mandatory rules), Article 16 (which provides for certain overriding rules) and Article 18 (public policy) of the Schedule to the RTO all of which are described and considered more fully in paragraphs 3.6 and 3.7 of this Section II.

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

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

(i) that personal creditors of the trustee shall have no recourse against the trust assets;

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

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[17] Articles 6 and 7 of the Schedule to the RTO.

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

In particular that law shall govern—

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

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

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

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

(e) the powers of investment of trustees;

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

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

(h) the variation or termination of the trust;

(i) the distribution of the trust assets;

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

[19] However, the RTO does not apply to the validity of acts by which assets are transferred to trustees (Article 4 RTO) and does not cover the rights and obligations of third parties to the trust with respect to the trust property.

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

3.3 Application of the RTO to the Agent-Trust and the U.S. Trust

3.3.1 In the case of the Agent-Trust:

(i) there are good arguments that the Agent-Trust falls within the definition of a "trust" under the RTO as the Customer Transactions are placed under the control of the FCM[20] for the benefit of a Customer. The Agent-Trust also fulfils each of the three characteristics in the definition set out Article 2 of the Schedule to the RTO;[21]

(ii) if the RTO is applicable, it would provide that New York law would be recognised as the governing law of the Agent-Trust by an HKSAR court, with the consequences as spelled out above; and

(iii) notwithstanding the arguments in footnote 22 of this Memorandum, there is some residual uncertainty as to whether the RTO would apply to the Agent-Trust, firstly because there is no declaration of trust in writing and secondly because the Customer retains some control over the Customer Transactions. Hence, for completeness, we also consider the recognition under HKSAR common law principles.

3.3.2 In the case of the U.S. Trust:

(i) subject to footnote 6 of this Memorandum, the U.S. Trust clearly falls within the definition of a "trust" under the RTO as the assets are similarly placed under the control of the FCM for the benefit of a Customer and the U.S. Trust fulfils each of the three characteristics contained within the definition set out in Article 2 of the Schedule to the RTO;

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[20] As the legal title-holder of the Customer Transactions, the FCM arguably has control of the Customer Transactions (which it holds for the benefit of the Customers). We note however, that unlike a classic trustee, in its capacity as "agent-trustee", the FCM holds title to the Customer Transactions "subject to the control of its principal" (see footnote14 of the Summary Annex), which reflects the nature of the agency relationship between the parties. Although this may on the face of it appear to contradict the RTO requirement, we think the better interpretation of this is that the FCM has control over the Customer Transactions but its rights as legal title-holder are fettered by the Customer's right to direct the FCM in respect of the Customer Transactions pursuant to the provisions of the Clearing Agreement and we note from paragraph 3.2.2 of this Section II that "*[t]he reservation by the settlor of certain rights and powers … are not necessarily inconsistent with the existence of a trust*" (although this view is not free from doubt).

[21] The trustee's fiduciary obligations (owed as trustee, as opposed to fiduciary obligations owed in any other capacity) appears to be a core feature of an in-scope trust for the purposes of Convention (see Paragraph 40 of the Explanatory Report to the Hague Convention). As the RTO implements the Convention, HKSAR courts may decide to apply the same construction while analysing trust arrangements under the RTO. We understand from the description of the Agent-Trust in the Summary Annex that the fiduciary obligations owed by the FCM to the Customer arises under the agency relationship rather than the trust relationship. This may weaken the argument in favour of the Agent-Trust being a type of RTO trust, notwithstanding that on the face of it, the three characteristics contained within the definition set out in paragraph 3.2 of this Section II appear to be met.

(ii) however, as noted above, there is an argument that trusts created by statute cannot be considered to have been created voluntarily (within the meaning of the RTO) and thus would not fall within the RTO. In addition, as the U.S. Trust does not arise under the laws of the HKSAR, it cannot derive the benefit of the extension discussed in paragraph 3.2.3 of this Section II above;[22]

(iii) if the RTO is applicable, it would provide that U.S. Federal law is recognised as the governing law of the U.S. Trust by an HKSAR court. If the U.S. Trust is within the scope of the RTO, then the validity of the Statutory Trust would be governed by U.S. Federal law and under such law, we understand that the U.S. Trust is valid; and

(iv) as it is not certain that the U.S. Trust would fall within the scope of the RTO, we also consider in paragraph 3.4.1 of this Section II its recognition under HKSAR common law conflicts of law principles.

3.4 Validity of trusts outside the scope of the RTO

3.4.1 In the case of a trust that does not fall within the scope of the RTO, HKSAR common law conflicts of law rules will determine the law that governs the validity of the trust. Under the common law, the courts would look at the settor's express or implied choice of law, failing which the courts would seek to determine the law with which the trust was most closely connected. The HKSAR courts would also seek to give effect to the settlor's choice of law, whether express or implied. In seeking to determine what the implied choice of law is, the court will seek to have reference to a range of factors such as the terms of the instrument creating the trust (if any); the use of terminology resonant of a particular legal system or a form only in one system[23]; or the *lex situs* of the assets.[24] There are arguments to the effect that a settlor would not be able to choose an entirely unconnected governing law, or avoid by such choice some rule of law with which the trust was closely connected. If the settlor does not choose, either expressly or impliedly, the law which is to govern the trust, then the trust would be governed by the law with which it has the closest and most real connection.[25] In the case of the U.S. Trust, which arises under U.S. Federal law and where the DCO and FCM are located in the U.S., these factors would point to the implied choice of the settlor or the law which has the closest connection to the trust as being U.S. Federal law. Under such law, we understand that the U.S. Trust is a valid trust.

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[22] We note that there is an argument that the U.S. Trust could be understood to be entered into voluntarily because the parties enter into the Clearing Agreement voluntarily and it is as a result of this voluntary arrangement that the Statutory Trust is created. This can be contrasted with a trust arising "purely" as a result of statute, such as trusts created in cases of intestacy. However, this is not a very strong argument.

[23] *Dicey, Morris & Collins on the Conflict of Laws (*15th Edition*)* ("**Dicey**") at 29-019 suggests that this would be a strong indicator of the settlor's intentions though not determinative.

[24] Though Dicey op. cit. at 29-020 suggests that in the case of movables, this is a relevant, but not important, factor.

[25] In practice, Dicey *op. cit.* at 29-019, footnote 92 suggests that the common law cases do not distinguish between an implied choice of law and the applicable law in the absence of choice but instead look at a range of objective factors to determine the settlor's intentions.

3.4.2 For completeness, we address the characterisation of the Agent-Trust under HKSAR common law conflicts of law rules. As the Agent-Trust arises under the Clearing Agreement, which is governed by New York law, it would appear that HKSAR common law conflicts of law rules would determine that the law that governs the validity of the Agent-Trust would be New York law. Under such law, we understand that the Agent-Trust is a valid trust.

3.5 Characterisation of a trust under HKSAR law

3.5.1 If the governing law of the trust was not determinative of its characterisation, we would have to examine whether under HKSAR common law, the arrangement would be determined to be a trust, namely, looking at the characteristics of the arrangement and whether it appears to fulfil the definition of a trust as set out in paragraph 3.2.2. As it is clear that whether the RTO applies or not, the validity of the Agent-Trust and the U.S. Trust are governed by NY law or U.S. Federal law, as applicable, in this Memorandum we do not consider it necessary to analyse whether the Agent-Trust or the Statutory Trust would be characterised as a trust under HKSAR common law rules relating to trusts.

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

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

(i) the Agent-Trust is likely to fall within the RTO. However, there is doubt as to whether the U.S. Trust falls within the RTO;

(ii) if either the Agent-Trust or the U.S. Trust falls within the RTO, the governing law of the trust determines the characterisation and validity of the trust. This will be a matter of New York or U.S. Federal law respectively and we understand that in either case a valid trust exists under such laws; and

(iii) if either the Agent-Trust or (as is likely to be the case) the U.S. Trust does not fall within the RTO, the characterisation of either trust will be a matter of HKSAR common law conflicts of law regarding trusts. The analysis will point to the validity of the trust being a matter of New York or U.S. Federal law respectively and we understand that in either case a valid trust exists under such laws.

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

3.6.3 We have to consider whether there are any principles of HKSAR law that displace this conclusion. This could be in the following circumstances:

(i) neither the RTO nor the common law prevents the application of provisions of HKSAR law designated by HKSAR conflicts rules of the forum, in so far as those provisions cannot be derogated from by voluntary act, in certain areas related to trusts law;[26]

(ii) the RTO preserves the application of the mandatory rules of the forum which must be applied even to international situations, irrespective of conflict of laws;[27] and

(iii) irrespective of whether the RTO applies, if there is a provision of New York law or U.S. Federal law, as the case may be, that is manifestly incompatible with HKSAR public policy, it is possible that the HKSAR courts may not apply it.[28]

3.7 Application to the Agent-Trust and the U.S. Trust

3.7.1 Whilst there are a number of mandatory provisions that HKSAR law would apply in relation to trusts (for example, in relation to (i) the transfer of title to trust property and the creation of security interests over trust property where the *situs* of the trust property is in the HKSAR and (ii) the protection, in other respects, of third parties acting in good faith where the third party is located in the HKSAR), none of these provisions are directly relevant to the factual circumstances we have been asked to address. Mandatory provisions of HKSAR law that apply following commencement of insolvency proceedings are considered in paragraph 4 of this Section II below. Whether the Agent-Trust and the U.S. Trust give rise to a security interest subject to mandatory registration requirements is considered in paragraph 3.8 and below of this Section II.

3.7.2 In respect of the exception described in paragraph 2.1.2(v) above, it is necessary to consider whether application of all or any of the trust provisions constitute a penalty as a matter of HKSAR law. The two elements of the test in *Cavendish Square Holding BV v Talal El Makdessi*[29] as affirmed and applied in *Bank of China (Hong Kong) Ltd v Eddy Technology Co Ltd & Ors*[30] and *Re Hsin Chong Construction Co Ltd*[31] are discussed in paragraph 2.2.5 of this Section II. In our opinion, the provisions of the Agent-Trust and the U.S. Trust would not be considered a secondary obligation or to not have a relation to the legitimate interests of an innocent party and so would not constitute a penalty. Therefore, we do not believe that the trust provisions of the Agent-Trust and the U.S. Trust described in the S&C Memorandum would be manifestly incompatible with HKSAR public policy.

3.7.3 Therefore, it does not appear to us that any of the exceptions considered above apply and thus New York law would be recognised as the governing law of the Agent-Trust and U.S. Federal law would be recognised as the governing law of the U.S. Trust.

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[26] Article 15 of the Schedule to the RTO.

[27] Article 16 of the Schedule to the RTO.

[28] Article 18 of the Schedule to the RTO.

[29] [2015] UKSC 67.

[30] [2019] 5 HKC 496.

[31] [2020] HKC 151.

3.8 Risk of characterisation as a security interest under HKSAR law

3.8.1 It might be argued that there are certain similarities between the Agent-Trust and U.S. Trust arrangements under the U.S. Clearing Model and a security arrangement under HKSAR law and so we have to consider whether an HKSAR court may characterise those arrangements as creating a security interest.

Nature of a security interest

3.8.2 A security interest is created when a party ("**Party A**") grants another party ("**Party B**") a specifically enforceable right in the relevant property of Party A to secure the payment or discharge of a debt or other obligation owed by Party A to Party B and the relevant property is given as security only, not by way of outright transfer. The right is by way of grant of an interest in the debtor's asset, not by way of reservation of title to the creditor.[32]

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

(i) a security interest entitles the grantor of the interest to recover the subject property, before the security is enforced, by returning the money initially paid to the grantor by the holder of the security interest. This right is the "equity of redemption";

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

(iii) conversely, if property the subject of a security interest realises on sale less than is required to discharge the relevant secured obligations, the grantor of the security interest remains liable for the shortfall.[33]

Recharacterisation as a security interest

3.8.4 The S&C Memorandum concludes that the Agent-Trust and U.S. Trust arrangements are trusts as a matter of U.S. law, the Customer's beneficial interests in which are subsequently subject to a security interest. Contrary to this however, it might be argued that, viewed as a whole under HKSAR law, each of the Agent-Trust and the U.S. Trust is better characterised under HKSAR law as a trust that also simultaneously creates a security interest in favour of the FCM over all or part of the Agent-Trust Property and

[32] *McEntire v Crossley Bros* [1895] A.C. 457; as cited by the HKSAR Court of Appeal in *HKSAR v Woo Mei Bo Mable* [2003] HKCU 971.

[33] [1933] Ch 1 (CA) 27-28. As applied in the HKSAR Court of Final Appeal case of *Secretary for Justice v Global Merchant Funding Ltd* [2016] HKCU 1135 and the Hong Kong Court of Appeal case of *Chase Manhattan (Asia) Ltd v First Bangkok City Finance Ltd* [1988] HKC 97.

Statutory Property, as applicable.[34] It has been acknowledged that a trust arrangement may also be characterised as a security arrangement under HKSAR law.[35]

3.8.5 In *Welsh Development Agency v Export Finance Co Ltd*[36], the English Court of Appeal used a two-fold test to determine how an agreement should be characterised. First, the court must establish whether the documents constitute a sham intended to mask the true agreement of the parties. Second, the court must establish the proper legal characterisation of the actual legal relations between the parties.

3.8.6 Applying this to the Agent-Trust and the U.S. Trust:

(i) The Agent-Trust as a security interest

(a) There are certain features of the Agent-Trust which are similar to the features of a security interest. These similarities could support an argument that the Agent-Trust, as a matter of HKSAR law, creates a security interest in favour of the FCM over the Customer Transactions, as opposed to being a trust with a separate security interest over the Customer's beneficial interest in the Customer Transactions (as set out in the S&C Memorandum and the Summary Annex and to the extent such a security interest is created):

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

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

(b) However, notwithstanding these similarities, legal title to the Customer Transactions is held by the FCM from the moment that a Customer Transaction is established with the DCO (or Foreign Futures Broker) – at no time does the Customer hold legal or beneficial title to a particular

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

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

[36] [1992] BCLC 148 (CA), as applied in the HKSAR Court of Appeal case of *Secretary for Justice v Global Merchant Funding Ltd* [2015] HKCU 736.

Customer Transaction. We understand that as soon as the Customer Transactions are entered into, they form part of the Agent-Trust Property held by the FCM and whilst the Customer has a beneficial interest in the Agent-Trust Property as a whole (or multiple *pro rata* beneficial interests in subsets of the Agent-Trust Property, reflecting the Customer Transactions cleared by the FCM for that Customer), the Customer does not have a beneficial interest in any specific Customer Transaction or a beneficial interest in the Customer Transactions outside the Agent-Trust. Having not previously held the legal title or the beneficial title to a particular Customer Transaction, the Customer could not, therefore, have created a security interest over the Customer Transactions.

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

(ii) The U.S. Trust as a security interest

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

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

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

However, it is important to note that the Statutory Property is not exclusively comprised of Customer Funds, but also includes the FCM's Residual Interest and other assets delivered into segregation (see paragraph 1.4.3 of this Section II) (which together constitute the Segregated Funds and Separate Account Funds, as applicable). As explained in paragraph 1.13, 1.13, 1.16 and 1.20 of the Summary Annex, the FCM is required (a) in respect of the Customer Funds of US Futures customers and Cleared Swaps customers, pursuant to the segregation rules, and (b) in respect of the Customer Funds of Foreign Futures

customers, pursuant to the separate account rules, to maintain its own funds (which may mean it is required to deposit its own funds) in the Segregated Funds Account or Separate Accounts, as applicable, (which are commingled with the Customer Funds) as a cushion of proprietary funds in order to protect against becoming under-segregated by failing to hold a sufficient amount of Segregated Funds or Separate Accounts, as applicable, to meet the CFTC's segregation or separate account requirement as applicable.

(b) Such obligation of the FCM to deposit or maintain its own funds to the Segregated Funds Account and Separate Account, as applicable, is inconsistent with the creation of security by the Customer over the Segregated Funds and Separate Account Funds, as applicable, because, whilst the Customer has a beneficial interest in the Statutory Property as a whole (or multiple beneficial interests in sub-pools or classes of assets included in the Statutory Property)[37], the Customer does (or, in the case of (b), did) not have a beneficial interest in either (a) any specific asset comprised in the Segregated Funds or Separate Account Funds (as applicable), or (b) the Segregated Funds or Separate Account Funds (as applicable), transferred into a U.S. Trust by someone other than it (including a DCO, a Foreign Futures Broker or a different customer). Having not previously held the legal title or the beneficial title to the proprietary funds of the FCM or funds transferred to the FCM by a DCO (or Foreign Futures Broker or different customer), the Customer could not, therefore, have created a security interest over the Segregated Funds or Separate Account Funds (as applicable). The existence of a Residual Interest is also more consistent with the characterisation of the a U.S. Trust as a trust rather than as a security interest.

(c) Additionally, we understand from the S&C Memorandum and the Summary Annex that the FCM has in respect of each Statutory Arrangement, under the terms of the Clearing Agreement and each Statutory Arrangement, by way of operation of New York law and U.S. Federal law as applicable,[38] a right to withdraw funds from the Statutory Property comprised in the relevant Statutory Arrangement for certain "Permitted Uses" and "Proprietary Uses" as more particularly described

[37] See our assumption in paragraph 6.16 of Section I and paragraph 1.4.2 of Section II.

[38] Even without the express authorization contained in the customer agreement, the Restatement (Second) of Agency provided that:

An agent whose principal violates or threatens to violate a contractual or restitutional duty to him has an appropriate remedy. He can, in a proper case … exercise the rights of a lien holder…" at page 117.

"*Under both common law and (we assume) the customer agreement, as well as under Section 4d of the CEA, the FCM has the right, when accounting to its customer, to deduct any advances made from the balance of the customer account*" at page 123. "*The legislative history surrounding the adoption of the safe harbors for commodity contracts in the U.S. Bankruptcy Code supports the conclusions that both the industry and the sponsors of the safe harbors recognized an FCM's ability to enforce its lien against the customer account and set off amount following a customer default*" at page 124.

in the S&C memorandum and paragraphs 1.19 and 1.20 of the Summary Annex:

Permitted Uses

The FCM is permitted to withdraw from segregation or separate accounts (as applicable) and apply Statutory Property in respect of each Account Class as necessary in the normal course of business to margin, guarantee, secure, transfer, adjust or settle a Customer's transactions with a DCO (or Foreign Futures Broker) or (in respect of Segregated Funds) another FCM, including (in respect of Segregated Funds) to pay commissions, brokerage, interest, taxes, storage and other charges incurred in connection with that Customer's Customer Transactions. As noted in paragraph 1.19 of the Summary Annex, the Permitted Uses for which the FCM can withdraw funds directly from the Statutory Property also includes some of the costs and expenses incurred during a Liquidation and in the exercise of its rights under the Clearing Agreement following a Customer's default.

Proprietary Uses

Separately and as noted in paragraphs 1.18 of the Summary Annex, the segregation rules and separate account rules also permit the FCM to withdraw funds from the Statutory Property for its own proprietary uses up to the value of its Residual Interest, subject to certain limitations and conditions ("**Proprietary Uses**"). The FCM may not withdraw amounts directly from the Statutory Property to meet Chargeable Costs. The FCM may, however, debit Chargeable Costs from the Customer's Account, which causes a corresponding reduction in the Customer's Net Liquidating Equity and a corresponding increase in the FCM's Residual Interest. We understand that the effect of this arrangement is to satisfy the Chargeable Costs (as they have been charged to the Customer Account) and increase the FCM's beneficial interest in the relevant Statutory Arrangement (its Residual Interest), allowing the FCM to withdraw amounts from the relevant Statutory Arrangement for Proprietary Uses, which amounts become the property of the FCM upon withdrawal. [39] The Residual Interest of the FCM in each Statutory Arrangement is structurally subordinate to each Customer's entitlement to the Net Liquidating Equity as it is determined by exhaustion once each Customer's Net Liquidating Equities have been determined. In our view, in respect of each U.S. Trust, a Proprietary Use is analogous to the power of the FCM to return excess Customer Funds to a Customer and both effectively amount to the power of the FCM as trustee to allocate trust

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

assets to or for the benefit of defined beneficiaries of a trust in accordance with the terms of the trust.

(d) In the event of a Customer default, the FCM is entitled to effect a Liquidation. We understand and have assumed in paragraph 6.12 of Section I of this Memorandum that, in conducting a Liquidation the FCM will only withdraw amounts from the Statutory Property for Permitted Uses or Proprietary Uses. We need to consider what the proper characterisation of such uses are under HKSAR law for the purposes of determining whether such characterisation raises any HKSAR law requirements for their validity.

(e) As noted earlier, Permitted Uses are those purposes that entitle the FCM to use the Statutory Property directly to discharge permitted costs and expenses of the relevant Statutory Arrangement rather than having first to discharge these costs and expenses out of its own resources and seek reimbursement from the Customer or the Statutory Arrangements. We understand that the FCM's right or power to apply such amounts exists under the terms of each Statutory Arrangement and is not considered to amount to the enforcement of a security interest under applicable U.S. law. In our view, in respect of each U.S. Trust, Permitted Uses equate to a conventional power of a trustee to deal with trust assets in the administration of a trust and it would not therefore, be characterised as a security interest.

(f) We also need to consider whether the arrangement by which the FCM has the right to charge Chargeable Costs to the Customer Account, coupled with the FCM's entitlement to withdraw the Statutory Property for Proprietary Uses, amounts to a security interest under HKSAR law. In our view, it does not. As noted previously, a security interest involves the creation of a proprietary interest in an asset owned by Party A in favour of Party B to secure a liability of Party A to Party B. When the liability is discharged, Party A is entitled to the return of the asset by virtue of the equity of redemption. In the context of a U.S. Trust, the state of the Customer Account is determinative of the Customer's beneficial interest in the Statutory Arrangement(s).[40] There is no liability for the Customer Funds to secure and an entitlement to Customer Funds only exists when the Customer Account has a positive balance.

(g) Further, the fact that the terms of a U.S. Trust do not secure any specific or particular obligation of the Customer to the FCM strengthens this argument. It is clear from the above analysis that the terms of a U.S. Trust permit the FCM to apply Statutory Property comprised in the

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

relevant Statutory Arrangement to enable the FCM to perform its obligations incurred in connection with the Transactions, which are held on the Agent-Trust or for its own proprietary uses. The purpose of the U.S. Trust is therefore, to enable the FCM to use the Statutory Property either for the purpose of administering relevant Statutory Arrangement or for allocating the Statutory Property to or for the benefit of defined beneficiaries of the relevant U.S. Trust in accordance with the terms of the U.S. Trust. This analysis is consistent with the recognition (under the RTO or HKSAR common law) of the U.S. Trust as a trust arrangement, with the Permitted Uses and Proprietary Uses each forming part of such a trust arrangement, and inconsistent with the characterisation of any of a U.S. Trust, Permitted Uses or Proprietary Uses as a security interest. In our view, therefore, an HKSAR court would not characterise the arrangements under a U.S. Trust as a security arrangement in favour of the FCM over the Segregated Funds and Separate Account Funds which constitute the trust property.

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

Summary

- We consider the interaction of the HKSAR insolvency principles and insolvency clawback rules with the trust arrangements under the U.S. Clearing Model and the grant of the Security Interest, in particular with the Position Liquidation, Margin Liquidation and Determination of Account provisions.
- We also consider the interaction of the HKSAR insolvency principles and insolvency clawback rules with the grant of the Security Interest.

We note that the liquidation provisions of the U.S. Clearing Model may apply following the default of a Customer both before and after the commencement of insolvency proceedings in respect of the Customer. The analysis in paragraphs 2 and 3 of this Section II considers the position before the commencement of insolvency proceedings in respect of the Customer. This paragraph 4 considers the interaction of HKSAR insolvency principles and insolvency clawback rules with the trust arrangements under the U.S. Clearing Model and the grant of the Security Interest.

4.1 HKSAR Insolvency Principles

4.1.1 If HKSAR insolvency proceedings are commenced in respect of the Customer, the question arises as to whether certain transactions which took place before or after the commencement of winding up of the Customer might be affected by reason of: (i) any of the principles of HKSAR insolvency law; or (ii) any avoidance powers of a liquidator.

4.1.2 The impact of the mandatory provisions of HKSAR insolvency law and the avoidance powers of a liquidator may have to be considered in relation to the Transactions entered into by an HKSAR Company. However, a Customer is not a party to the Transactions,

which are entered into on a principal-to-principal basis between the FCM and the DCO (or Foreign Futures Broker). Upon a default of a Customer, the liquidation of Customer Transactions (and any related positions) is effected in accordance with the Clearing Agreement, including the rules of each relevant DCO (or the clearing agreement between the FCM and its Foreign Futures Broker). In effecting this liquidation, the FCM will be closing out and entering into contractual arrangements and transactions with DCOs (or Foreign Futures Brokers) and other third parties as permitted by the Clearing Agreement. The Customer will not be closing out or entering into such contractual arrangements and transactions.

4.1.3 As noted in paragraphs 1.10 and 1.11 of the Summary Annex, there are no separate transactions as between the Customer and the FCM. Rather, there is an overall duty of the FCM to account to the Customer for the net amount due under the terms of the Agent-Trust and the U.S. Trust. On the assumption that New York law and U.S. Federal law provide that a Customer's beneficial interest(s) in the Agent-Trust Property or any U.S. Trust is not an interest in any specific asset that constitutes the relevant trust but rather is a beneficial interest in the relevant Trust Property as a whole (or multiple beneficial interests in subsets of the Agent-Trust Property or sub-pools or classes of assets included in the Statutory Trust Property (as applicable))[41], HKSAR law would not treat the Customer as having an ownership right in any specific item of the relevant Trust Property outright.[42]

Position Liquidation, Margin Liquidation and Determination of Account

4.1.4 As set out in the Summary Annex, following a default by the Customer, the FCM brings about the liquidation of Customer Transactions by way of:

(i) Position Liquidation, which may include (a) entering into certain transactions with the DCO (namely, Offsetting Transactions, risk-reducing transactions or hedging transactions and/or any other transaction entered into in order to effect a Position Liquidation (if any)), or (b) causing the DCO or foreign clearing organisation to debit or otherwise remove the FCM's omnibus customer positions account (or the Foreign Futures Broker's omnibus customer positions account maintained by the foreign clearing organisation) by book-entry transfer of 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; and

(ii) Margin Liquidation.

4.1.5 Following the determination of the cumulative increase or decrease to the Customer's cash balance resulting from the Position Liquidation and Margin Liquidation (as described in paragraph 2.9 of the Summary Annex), the FCM will determine the

[41] See the assumption in paragraph 6.16 of Section I.

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

Determination of Account payable in connection with the liquidation (which may include its own properly incurred costs and expenses).

4.1.6 As described in paragraph 2.10 of the Summary Annex, 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. As described in paragraphs 2.11 - 2.15 of the Summary Annex, the determination of a single aggregate credit or debit balance in respect of the Customer Account may be achieved, at the option of the FCM, through a choice of legal methods described in those paragraphs, being (A) a determination of a single account and not set-off, (B) a set-off of amounts held on trust for the Customer against a liability owed by a Customer to the FCM, (C) the charging of Chargeable Costs to the Customer Account leading to an increase in the value of the FCM's Residual Interest and the withdrawal by the FCM of its Residual Interest for Proprietary Uses, and (D) the enforcement by the FCM of the Security Interest to discharge liabilities for an Account Class.

4.1.7 The rules of HKSAR insolvency law that have to be considered are:

(i) *the insolvency set-off rules*: the insolvency set-off rules[43] which apply to mutual credits, mutual debts and other dealings of an insolvent entity and provide a set mechanic and procedure for ensuring, provided certain requirements are met, that a party's various dealings with its counterparty will be mandatorily and automatically set off against each other following the winding-up of that counterparty. Section 35 of the BO will not however be relevant to the liquidation of the Agent-Trust Property and any Statutory Property by an FCM within a single Account Class following the commencement of insolvency proceedings in respect of a Customer because following the liquidation of Customer Transactions by the FCM, any gains or losses resulting from the liquidation will be reflected in the Net Liquidating Equity of the Customer and a single net amount is determined which represents the Customer's entitlement under the Clearing Agreement. Whilst this may appear to be a form of netting or set-off, in relation to the Clearing Agreement, the Customer only ever has an entitlement to this single net amount. This represents a determination of the overall value of the single course of dealing between the FCM and the Customer rather the exercise of set off in respect of a number of different transactions – there are no distinct transactions or obligations that are separate from the proprietary interest of the Customer in (x) the Agent-Trust Property or the Statutory Property, on the one hand or (y) the Customer's entitlement under the Clearing Agreement, on the other hand. To the extent, however, that (a) the Customer's Account comprises multiple Account Classes, (b) there is a separate Determination of

[43] This refers to section 35 of the BO, which is applied to the insolvency of Companies by section 264 C(WUMP)O.

Account for each Account Class, (c) a single Determination of Account across all Account Classes in respect of the Customer Account is achieved, and (d) such single Determination of Account involves a set-off, such set-off will only be permitted to the extent that it complies with the mandatory insolvency set-off rules to the extent that they apply.

(ii) *the pari passu rule*: the court has an inherent general equitable power to avoid a transaction under which a debtor treats one creditor preferentially, as compared to other creditors and where the creditor in question knows at the time of the transaction that the debtor is in financial difficulties.[44] The object of the exercise of this power appears to be to protect the principle that all creditors should be treated *pari passu*. This equitable power has not been widely used, and, in the context of corporate insolvencies, appears to have been displaced by the provisions of the C(WUMP)O relating to preferences. In our view, the HKSAR courts would follow the English House of Lords case of *British Eagle*[45] and hold that the parties to an agreement cannot contract out of this *pari passu* rule. It could be argued that the application by the FCM of the Statutory Property to Permitted Uses or Proprietary Uses following the commencement of insolvency proceedings in respect of the Customer where other creditors of the Customer do not recover amounts owed to them in full, would contravene the *pari passu* rule. We understand however, that under applicable U.S. law the Permitted Uses and Proprietary Uses are an inherent element of the U.S. Trust and, in the case of Permitted Uses, rank ahead of (because it is determinative of) the Customer's interests in the Statutory Property (see our discussion in respect of Permitted Uses in paragraph 3.8.6(ii) paragraph (d) onwards of this Section II) and, in the context of Proprietary Uses, only arises when the FCM has a Residual Interest in a U.S. Trust and so does not involve the allocation of property belonging to the Customer. The Customer's interest in the Statutory Property is, therefore, limited to the Net Liquidating Equity and thus subject to the FCM's right to withdraw funds for Permitted Uses and Proprietary Uses; and

(iii) *the anti-deprivation rule*: the anti-deprivation rule is a separate, but parallel, principle to the *pari passu* rule which states that a person cannot agree that their property will be forfeited or transferred to another, or confiscated, on their insolvency. Similarly, any provisions to the effect that amounts payable by the insolvent party under a contract are increased upon insolvency are unenforceable. The anti-deprivation rule would only be relevant in the context of the U.S. Clearing Model if, on the insolvency of a Customer, the terms on which Customer Transactions or Statutory Property are liquidated meant that there was some form of deprivation (e.g. Transactions or Statutory Property are taken away

[44] *Watts v Christie* (1849) 11 Beav. 546, 50 ER 928. This case has been cited with approval on a separate point in *Gail Stevenson and Another v the Chartered Bank* [1977] HKCU 66.

[45] *British Eagle International Airlines Limited v Compagnie Nationale Air France* [1975] 2 All ER 390. The case has been applied in *Peregrine Investments Holdings Ltd & Another v Asian Infrastructure Fund Management Co Ltd LDC & Others* [2003] 1 HKC 455 and affirmed in the appeal case *Peregrine Investments Holdings Ltd & Another v Asian Infrastructure Fund Management Co Ltd LDC & Others* [2004] 1 HKLRD 598. Also see *Re Lam Fung & Another* [2003] HKEC 303.

from the FCM for no value or a reduced value so as to deprive the Customer's interest in the Agent-Trust Property or Statutory Property of value).

(iv) In our view a Liquidation of the Agent-Trust Property and the Statutory Property would not be considered to be a deprivation as there is no property which is forfeited or confiscated or amount payable increased – the Liquidation Process simply produces a single net amount after the deduction of all costs, expenses and liabilities incurred by the FCM for the account of the Customer that are properly chargeable to the Customer, which is reflected in the balance of the Customer Account and represents the Customer's entitlement in respect of the Statutory Property (being the Net Liquidating Equity), which, in any case, is the extent of the Customer's beneficial interest in such Statutory Property at any point. The anti-deprivation rule was considered in the English Supreme Court case of *Belmont Park*[46] where it was held that a "common sense application" of the rule was required in each case. The judgments in *Belmont Park* propose that the correct approach is essentially one of analysing whether or not the arrangements are designed improperly to get around the insolvency principles. The starting point is that a "*deliberate intention to evade the insolvency laws is required*"[47]. This is not a purely purposive test – "*that does not mean of course that a subjective intention is required, or that there will not be cases so obvious that an intention can be inferred*". But "*a commercially sensible transaction entered into in good faith should not be held to infringe the anti-deprivation rule*"[48]. "*The Court has to make an objective assessment of the purpose and effect of the relevant transaction or provision in bankruptcy, when considering whether it amounts to an illegitimate evasion of the bankruptcy law or has a legitimate commercial basis in other considerations*"[49]. It was also clear that the courts will be slow to strike down "*a complex commercial transaction entered in good faith*"[50]. We have assumed[51] that the arrangements under the U.S. Clearing Model are entered into for *bona fide* commercial reasons and our understanding is that they are not intended to evade insolvency principles. Consequently, we consider that a Liquidation of the Agent-Trust Property and the Statutory Property do not contravene the anti-deprivation rule.

4.1.8 In addition, the HKSAR insolvency clawback provisions should be considered. Taking each in turn:

(i) *Dispositions following the commencement of winding up*: Any disposition of an insolvent party's property, for example a payment under a transaction, made after the commencement of the winding-up is, unless the HKSAR court orders otherwise, void (section 182 of the C(WUMP)O). The HKSAR court has the

[46] [2011] UKSC 38. This case is applied in *Re Hsin Chong Construction Co Ltd* [2020] 1 HKC 151.

[47] At paragraph 78.

[48] At paragraph 79.

[49] At paragraph 151.

[50] At paragraph 109.

[51] See paragraph 6.5 of Section I.

discretion to validate a disposition if it was made honestly in the ordinary course of business after the date, or the deemed date of the winding-up order. Hence if the security interest was granted after the Lender has become insolvent, the security interest may be void. For these purposes the date of commencement of the winding-up is deemed to be the date of the winding-up order or the deemed date of the winding-up order. If the FCM effects a Margin Liquidation or Position Liquidation following the commencement of the winding-up of the Customer, or withdraws amounts from the Statutory Property for Permitted Uses or Proprietary Uses, this could be argued to be a breach of section 182 of the C(WUMP)O. However, on the understanding that the Customer's trust entitlement is to the Net Liquidating Equity as described in the Summary Annex and the Residual Interest comprises of the FCM's own funds, a withdrawal of funds by the FCM for Permitted Uses or Proprietary Uses would not be regarded as the disposition of an asset of the Customer, This is clearly the case in respect of the Agent-Trust Property or any U.S. Trust Property because the Customer does not have an interest in any specific Customer Transaction or U.S. Trust Property;

(ii) *Cherry picking:* A liquidator generally has a power to assume profitable contracts and to reject unprofitable contracts (which is often referred to as "**cherry-picking**") under section 268 of the C(WUMP)O. As the Customer is not party to the Transactions, which are entered into between the FCM and a DCO (or Foreign Futures Broker), they could not be considered as "onerous property" of the Customer and could not, therefore, be disclaimed. The only contract that could be disclaimed is the Clearing Agreement and it is not possible to disclaim a part of it;

(iii) *Transaction at an undervalue:* under section 265D(2) of the C(WUMP)O, the HKSAR Court of First Instance has the power to set aside a transaction at an undervalue which is entered into by a company within five years before the commencement of its winding-up, but only if the Customer is unable to pay its debts at the time it enters into the transaction or becomes unable to pay its debts as a result of the transaction. The court must not make an order if it is satisfied that the Customer entered into the transaction in good faith and for the purpose of carrying on its business; and at the time the Customer did so, there were reasonable grounds for believing that the transaction would benefit the Customer.[52] As discussed in paragraph 4.1.8(ii) above, the Customer does not enter into the Transactions and so they could not be considered to be at an undervalue as regards the Customer. In the unlikely event that the transfer of Customer Funds from the Customer to the FCM is considered by an HKSAR court to be a transaction, we believe that the exemption discussed above (in relation to the transaction being entered into in good faith, for the purpose of carrying on the Customer's business and for the benefit of the Customer) would apply;

[52] As stipulated in section 265D(4) of the C(WUMP)O.

(iv) *Preferences:* Any conveyance, mortgage, delivery of goods, execution or other act relating to property made or done by or against a counterparty within six months[53] before the commencement of its winding-up with a view to giving a creditor a preference over other creditors, may be set aside as an unfair preference under section 266 of the C(WUMP)O. There is no express provision protecting a creditor who did not know of the actual insolvency of his counterparty or of his preferential motive. However, a court cannot make an order under that section 266 unless the required intention is present. We have assumed in paragraph 6.5 of Section I above that all of the Transactions were entered into at arm's length so that no element of gift or undervalue from the insolvent party to the other party is involved and without any intention of the insolvent party to prefer the other party so that section 266 would not apply even were it to apply to Transactions to which the Customer is not a party. We understand and assume that the transfer of Customer Funds by the Customer is not influenced by the desire to prefer the FCM but, rather, reflects the operation of the Clearing Agreement, the applicable rules of the DCO (or the applicable clearing agreement between the FCM and its Foreign Futures Broker), the Agent-Trust and the U.S. Trust in accordance with their terms;

(v) *Dispositions made with the intent to defraud creditors*: Section 60 of the CPO contains similar provisions relating to dispositions made with the intent to defraud creditors but does not apply to a disposition for valuable consideration and in good faith to a person not having notice of the intent to defraud creditors. This is another reason for the assumption in paragraph 6.5 of Section I above[54]; and

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[53] References to the "twilight period" of six months in section 266 are extended to a period of two years in the case of a transaction with a person who is connected with the company (otherwise than by reason only of being its employee). Pursuant to section 265A(3) of the C(WUMP)O, a person is connected with a company if that person is:

(a) an associate of a director or shadow director of the company; or

(b) an associate of the company.

The meaning of "associate" of a company is further set out in section 265B and section 265C of the C(WUMP)O as including (but not limited to) the following:

(a) various family members of the director or shadow director of the company;

(b) individuals who are employed by the company; and

(c) entities that are controlled by the same person or group of persons who also have control over the company.

Under section 265C of the C(WUMP)O, a person has control of a company if:

(a) any or all of the directors of the company, or of another company which has control of it, are accustomed to act in accordance with that person's directions or instructions; or

(b) that person is entitled to exercise, or control the exercise of, more than 30% of the voting power at any general meeting of the company or of another company which has control of it.

It should further be noted that if two or more persons together satisfy either paragraphs (a) and (b) above, they have control of the company in accordance with section 265C of the C(WUMP)O.

[54] The interpretation of section 60 of the CPO was considered recently by the HKSAR Court of Final Appeal in *Tradepower (Holding) Ltd v Tradepower (Hong Kong) Ltd*. [2010] 1 HKC 380 ("**Tradepower**"). In that case, the HKSAR Court of Final Appeal considered the extent to which the "rule in Freeman v Pope" (the "**Rule**") applies in the context of section 60 of the CPO. Briefly, the Rule provides that proof that a voluntary disposition was made by a person while insolvent or which results in his insolvency so as to deplete the fund from which his creditors' claims might be satisfied was sufficient proof of an intent to defraud creditors. It was unnecessary to prove the actual intent of the disposor in such cases.

(vi) *Extortionate credits:* Section 264B of the C(WUMP)O makes provision for the court, upon the application of a liquidator, to reopen a transaction where credit was provided to a Counterparty and the transaction was "extortionate". The provision applies if a winding-up commences within a suspect period of three years of the transaction and "extortionate" is defined as grossly exorbitant payments or credits which otherwise grossly contravene ordinary principles of fair dealing. As the Customer is not a party to the Transactions, section 264B cannot apply to it. We understand and assume that the transfer of Customer Funds by the Customer to the FCM would not be held to be extortionate, but, rather, reflects the operation of the Clearing Agreement, the Agent-Trust and the U.S. Trust in accordance with their terms.

4.1.9 Accordingly, on the basis of the assumptions and analysis in this Memorandum, in our view, the mandatory principles of HKSAR insolvency law or HKSAR insolvency clawback provisions would not apply to:

(i) the Transactions;

(ii) the various methods by which an FCM can bring about a Position Liquidation and a Margin Liquidation in respect of the Agent-Trust Property and the Statutory Property in respect of which the Customer has a U.S. Trust Beneficial Interest (other than by way of enforcement of security, which is considered in paragraph 5 of this Section II); and

(iii) the Determination of Account in respect of the Agent-Trust Property and the Statutory Property in respect of which the Customer has a U.S. Trust Beneficial Interest, pursuant to which, following a Position Liquidation and a Margin Liquidation, a single net amount is determined by the FCM, which forms part of the Customer's Statutory Arrangement entitlement other than in relation to the insolvency clawback rules considered in paragraph 4.1.8 of this Section II or set-off or by way of enforcement of security, which is considered in paragraph 6.1 of this Section II).

4.2 Impact of the Customer's insolvency on the grant of the Security Interest

The creation of the Security Interest on the execution of the Clearing Agreement may be vulnerable to being set aside by the courts on the insolvency of the Customer if it offends any the rules of HKSAR insolvency law or the HKSAR insolvency clawback provisions.

4.2.1 HKSAR Insolvency clawback provisions:

In Tradepower, the HKSAR Court of Final Appeal held that, if it was objectively shown that a disposition of property unsupported by consideration was made by a disposor when or so as to become insolvent, resulting in current or future creditors being clearly subject at least to a significant risk of being unable to recover their debts in full, there would, subject to wholly exceptional circumstances presently unanticipated by the courts, inevitably be grounds to infer an intent to defraud creditors. However, where the Rule did not operate, whether due to the presence of valuable consideration or the absence of insolvency or relevant detriment to creditors, these being facts for objective determination, an actual intent to defraud creditors had to be shown as an inference properly to be drawn on the available evidence.

(i) The granting of a charge over property is capable of amounting to a disposition for the purposes of section 182 of the C(WUMP)O. We refer to our assumption in paragraph 6.4 of Part I of this Memorandum that the Clearing Agreement and Transactions will be entered into prior to the commencement of insolvency proceedings with respect to the Customer, meaning that the creation of the Security Interest will not, in our view, be void as a disposition under section 182 of the C(WUMP)O.

(ii) We refer to our assumption in paragraph 6.5 of Part I of this Memorandum that the Clearing Agreement and arrangements thereunder have been or will be entered into for *bona fide* commercial reasons, on arm's length commercial terms, meaning that the Clearing Agreement and the Security Interest will not amount to onerous property for the purpose of 268 of the C(WUMP)O, a transaction at an undervalue or a preference.

(iii) We refer to our assumption in paragraph 6.5 of Part I of this Memorandum that the Clearing Agreement and arrangements thereunder have been or will be entered into for *bona fide* commercial reasons, on arm's length commercial terms. As a result, we do not believe that the creation of the Security Interest will give rise to an extortionate credit transaction.

4.2.2 Anti-Deprivation Rule

We refer to our assumption in paragraph 6.4 of Part I of this Memorandum that the Clearing Agreement will not be entered into at a time described in that assumption, meaning that the creation of the Security Interest at that time will not, in our view, fall foul of the anti-deprivation principle.

4.2.3 *Pari Passu* Rule

The creation of the Security Interest will not, in our view, offend the *pari passu* rule as the Security Interest is a security arrangement in favour of the FCM, which becomes a secured creditor of the Customer, as opposed to granting the FCM (if it was an unsecured creditor) more than its proper share of the Customer's assets on insolvency.

4.3 Foreign currency debts

4.3.1 It is also necessary to consider whether, in the event that the FCM determines the single net amount which is the Customer's Statutory Trust entitlement in a currency other than Hong Kong dollars, an HKSAR court would enforce a claim for such amount in such currency and whether a claim for such amount can be proved in insolvency proceedings in the HKSAR without conversion into Hong Kong dollars.

4.3.2 Section 34(3B) of the BO provides that, where a debt provable is payable in a currency other than Hong Kong dollars, the liquidator shall convert the amount into Hong Kong dollars at the midpoint between the selling and buying telegraphic transfer rates quoted by the Hong Kong Association of Banks on the day after the bankruptcy/winding-up order is made or, where no such rates are quoted, at an exchange rate determined by the HKSAR court.

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

5 The law that determines the effectiveness of the Security Interest

Summary

- The law governing the proprietary aspects of a transfer of a movable asset is the *lex situs*.
- We consider the lex situs of the charged assets in the scenario where the Statutory Arrangement(s) are recognised as a valid trust under U.S. Federal or state law or where the Customer has a Securities Arrangement, a Cash Arrangement or a Cash Entitlement.
- In each case we consider that the situs of the arrangement is at the place of business of the FCM.

5.1 You have asked us to consider which law(s) a HKSAR court would consider to be the applicable law(s) to determine the effect of the creation of a security interest in the Customer's rights and interest in the Collateral. Under HKSAR rules of private international law, the relevant law governing the proprietary aspects of a transfer of a movable asset is the *lex situs*. [55] As a result, the *lex situs* governs the proprietary aspects of a security interest (including perfection and other formalities required to protect the Security Interest against competing claims).

5.2 We understand that the security will be over two types of property: (i) security over the contractual rights of the Customer against the FCM; and (ii) security over proprietary (or *in rem*) rights in respect of the Collateral.

5.3 Security over contractual rights

5.3.1 To the extent that the security is over the contractual rights of the Customer against the FCM, the *lex situs* of the Clearing Agreement will be relevant. Given that the *lex situs* of the Clearing Agreement should, on the basis of our assumptions, be New York (on account of both the governing law of the Clearing Agreement and the location of the FCM), this should point to New York law being the applicable law for determining the effectiveness of the Security Interest.

5.4 Security over Customer's proprietary interest in the Collateral

5.4.1 General principles

In the case of the Customer's proprietary interest in both Collateral in the form of cash and Customer Transactions, we understand that such proprietary interest may arise under a trust or, in the absence of a trust, under the UCC (or similar provisions of U.S. Federal or state law). Under HKSAR common law, the effectiveness of the creation of a

[55] *Dicey, Morris & Collins on the Conflict of Laws* (fifteenth edition 2012), chapter 24.

security interest over assets held on trust or subject to a similar arrangement (which, on the basis of section X.A.2(i)(1) of the S&C Memorandum, we would consider would extend to the Customer's entitlement under the UCC if such entitlement is not that of a trust) depends upon whether such security interest would be recognised under the law of the *lex situs* of the arrangement, namely under the UCC or U.S. Federal or state law as applicable.

5.4.2 *Situs* of arrangement

Under HKSAR common law, the *lex situs* of an arrangement will depend upon whether, under the law of the arrangement, the person entitled to the benefit of the arrangement has a specific property interest in each asset held under the arrangement or a general proprietary interest in all assets subject to the arrangement.[56] If the person entitled to the benefit of the arrangement has an ownership interest in the specific property subject to the arrangement, then the interest under the arrangement is located in the jurisdiction where that property is situated.[57] If the person entitled to the benefit of the arrangement is given merely a right (including a proprietary right) to claim against the holder of the property subject to the arrangement for the property,[58] then the interest under the arrangement is located where the action may be brought, i.e. at the place of residence of the holder of the property.[59]

We provide no opinion in relation to an arrangement, or property subject to an arrangement, to the extent that property subject to such arrangement has a *situs* in a jurisdiction that does not recognise the legal efficacy of such arrangement.

5.4.3 Security interest in Collateral in the form of cash

In the case of the Customer's proprietary interest in Collateral in the form of cash where the Customer has a Cash Arrangement or a beneficial interest in the cash in the nature of a U.S. Trust, on the basis of section X.A.2(ii)(2) of the S&C Memorandum and paragraph 1.40 of the Summary Annex, we understand that the Customer does not have a specific ownership interest in the bank accounts in which the FCM may hold any cash that represents such Customer Funds (and, indeed, we understand that there is unlikely to be a direct correlation between cash credited to all Customers' Customer Accounts and cash held by the FCM at its corresponding bank accounts reserved for Customer Funds in the form of cash), so it is clear that the interest under such arrangement is located at the place of business of the FCM.

In the case of the Customer's proprietary interest in Collateral in the form of cash where the Customer has a Cash Entitlement, such that the Customer has a specific ownership interest in the bank accounts in which the FCM deposits the Customer Funds in the form

[56] For example, if the Customer can claim a direct property interest in the cash at the bank to which it has been deposited by the FCM, as opposed to only a property right on the occasion of the insolvency of the FCM. An example of the former would be a Cash Entitlement and an example of the latter would be a Cash Arrangement.

[57] The relevant jurisdiction will therefore be the location of the bank account in which the FCM deposits the Collateral in the form of cash.

[58] The holder of the property will be the FCM.

[59] *Dicey, Morris & Collins on the Conflict of Laws* (16th Edition), paragraph 23-046.

of cash, the interest under such arrangement would instead be located at the place of the relevant bank account.

5.4.4 Security interest in Customer Transactions

(i) Customer Transactions that are not Foreign Futures

In the case of Customer Transactions that are not Foreign Futures, on the basis of section VI of the S&C Memorandum, we understand that the Customer does not have a specific ownership interest in the Customer Transactions subject to the arrangement but, rather, a beneficial interest in the Customer Transactions and a right to direct the FCM in relation to the dealings in such Customer Transactions, so it is most likely that the interest under the arrangement is located at the place of business of the FCM, although there is a possibility that the interest under the arrangement is located at the place of business of the CCP[60] at which such Customer Transactions are cleared.

(ii) Customer Transactions that are Foreign Futures

In the case of Customer Transactions that are Foreign Futures, we understand that the arrangement exists over the clearing agreement between the FCM and the clearing member acting for the FCM in respect of the Foreign Futures in respect of all Customer Transactions for all Customers. Therefore, it is even clearer that the interest under the arrangement is located at the place of business of the FCM.

5.4.5 Security interest over securities transferred by the Customer to the FCM.

For completeness we consider a Security interest over securities transferred by the Customer to the FCM (i.e. a Securities Arrangement).

There is some academic debate on how the location is to be determined in relation to certain types of asset for purposes of determining which law is the *lex situs*. We believe that the better view of current law is that the location of each of the following types of assets will be the place:

(i) in the case of a directly held bearer security, where the certificate is located;[61]

(ii) in the case of a directly held registered security, where the register is located;[62]

(iii) in the case of a directly held dematerialized security, the law of the jurisdiction establishing the statutory regime under which such dematerialized security is issued; and

[60] See paragraph 1.11 of the Summary Annex. If the FCM cleared a particular type of fungible contract for only one Customer, it is unclear whether this would confer on that Customer specific proprietary interests in the relevant contract at the DCO. If specific proprietary interests were conferred on that Customer, the interest under the arrangement would be located at the place of business of the DCO, not the FCM. However, this would not be a problem if the law of the relevant U.S. state recognised the effectiveness of the New York law governed security.

[61] *Attorney-General v Bouwens* (1838) 4 M&W 171.

[62] *Attorney-General v Higgins* (1857) 2 H&N 339.

(iv) in the case of intermediated securities, as discussed in below.

In the case of paragraph (iv), there will frequently be a chain (or tiers) of intermediaries holding the "same" security or, more accurately, recording an interest in the security on their records in favour of the next intermediary down the chain down to the ultimate holder. When determining the location of a particular person's holding of an indirectly held security, the location is the place of the account, register or other recording in book-entry form of its interest by the most immediate intermediary, regardless of where other links in the chain (that is, the immediate intermediary's own custodian, the custodian's sub-custodian and so on) may be located. This rule is sometimes referred to as the "place of the relevant intermediary approach" or "PRIMA".

Given that the securities transferred by the Customer to the FCM are likely to be held at the place of business of the FCM, the lex situs of the securities is likely to be the law of such place.

5.4.6 Conclusion

We take the view that, for a complex arrangement such as a clearing agreement, where it is clear that the *situs* of the arrangement in relation to many assets subject to it is at the place of the business of the FCM, an HKSAR court would likely conclude that where there is some uncertainty over the *situs* of the arrangement for some other assets (such as Customer Transactions that are not Foreign Futures and where such *situs* could be in several jurisdictions if the CCPs have their place of business in different U.S. states) a court would likely resolve this uncertainty by concluding that the *situs* of the entire arrangement is at the place of business of the FCM.[63]

5.5 Conclusion

Applying all the analysis above, including the assumptions and qualifications referred to, we are of the view that:

(i) the FCM and the Customer are free to choose New York law as the law creating the Security Interest over the Customer's non-proprietary contractual rights under the Clearing Agreement and this choice should be recognised by the HKSAR courts;

(ii) the HKSAR courts would recognise New York law as effective to create a Security Interest over the Customer's contractual rights against the FCM;

(iii) the HKSAR courts would recognise New York law as effective to create the Security Interest over the Customer's proprietary interest in Collateral in the form of securities;

(iv) the HKSAR courts should recognise New York law as the applicable law to determine the effectiveness of the creation of the Security Interest over the Customer's proprietary

[63] For example, if, as discussed in footnote 60 above, a particular type of fungible contract was cleared for only one Customer, an English court would likely conclude that the interest under the arrangement would still be located at the place of business of the FCM so that the *situs* of the arrangement would not change from the DCO to the FCM if another Customer were to open a position in the relevant type of contract.

interest in Collateral in the form of cash where the Customer has a beneficial interest in the cash in the nature of a U.S. Trust or a Cash Arrangement;

(v) the HKSAR courts should recognise the law of the location of the relevant bank account as the applicable law to determine the effectiveness of the creation of the Security Interest over the Customer's proprietary interest in Collateral in the form of cash where the Customer has a Cash Entitlement where the Customer has a specific ownership interest in the bank accounts in which the FCM deposits the Customer Funds in the form of cash; and

(vi) the HKSAR courts should recognise New York law as the applicable law to determine the effectiveness of the creation of the Security Interest over the Customer's proprietary interest in Customer Transactions, whether or not they are Foreign Futures.

6 Pre- and post-insolvency aspects of the security interest

Summary

- We consider the pre- and post-insolvency aspects of the Security Interest.
- We consider the enforceability of the provisions permitting withdrawals for Permitted Uses and Proprietary Uses.

6.1 Security interest under the Clearing Agreement

6.1.1 In addition and separate to the Agent-Trust and Statutory Arrangement(s), under the terms of the Clearing Agreement, the Customer grants a Security Interest. Given that the FCM as trustee or otherwise as intermediary has legal title to the Collateral, we understand that as a matter of New York law the Customer’s rights and interest in respect of the Collateral will not include legal ownership of the Collateral but other contractual and proprietary rights in and in respect of them.

6.1.2 The Security Interest secures liabilities of the Customer to the FCM that arise in connection with the Customer Agreement. However, we understand that there is little reason for the FCM to enforce the Security Interest, as the manner in which the contractual and trust arrangements are structured under the Clearing Agreement (as described in paragraphs 2.7 and 2.8 of the Summary Annex) entitles the FCM to liquidate the Customer Transactions and deduct amounts to cover liabilities, costs or expenses it has incurred in connection with the Customer Transactions and the liquidation process using its contractual and statutory rights, without any need to enforce the security interest. That said, we also understand the Security Interest serves the additional purpose in the U.S. of preventing third parties from gaining an intervening interest or otherwise interfering in the Customer Transactions or other property credited to the Customer’s accounts, or in the FCM’s rights to any proceeds realised from them, including any Statutory Arrangement that is not in the nature of a U.S. Trust. In addition, as discussed in paragraph 4.1.6 of this Section II, the FCM may wish to make a single Determination of Account across all Account Classes in respect of the Customer Account

through the enforcement by the FCM of the Security Interest to discharge liabilities for an Account Class.

6.1.3 As set out in the Summary Annex, and as discussed in paragraph 3.8 of this Section II, following a Customer's default, the FCM is entitled to enforce the Security Interest, in addition to liquidating the Customer's positions and determining the net amount in respect of which the FCM or Customer will have a duty to account to the other party.[64]

6.1.4 Nature of the Security Interest

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

(ii) Under HKSAR law, as discussed in paragraph 3.8 of this Section II, a security arrangement creates in favour of the secured party a security interest in an asset on terms that the security interest will be discharged once the security provider has performed the collateralised obligation.

(iii) We have assumed that in paragraph 6.16 of Section I that the Clearing Agreement is effective in order to, and does, create a specific security interest in the Customer's right and interest in the Collateral in favour of the FCM as a matter of New York Law. On this basis it is likely that the HKSAR courts would consider that the Security Interest creates rights which are in the nature of a security interest as understood under HKSAR law. The type of HKSAR law security interest which those New York law rights would equate to is beyond the scope of this Memorandum as we do not have any information about the precise terms of the security agreement or arrangement under which the Security Interest is created.[65] However, insofar as possible, we have considered the nature of the security interest insofar as this is relevant to HKSAR perfection requirements.

(iv) We now consider the effectiveness of the Security Interest.

6.1.5 Pre-insolvency enforcement of the Security Interest

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

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

[65] Under HKSAR law, a security interest can be fixed or floating in nature. It is important to note that the fixed or floating characterisation of a security interest does not depend on the terminology used by the parties and will instead depend on the legal characterisation of the arrangement based on the contractual rights and obligations of the parties. The characterisation of a security interest as floating security is likely to be detrimental to the collateral-taker since (contrary to the position in respect of a fixed security interest) its security will rank behind various competing claims on the collateral-provider's insolvency, enforcement may be affected in the event of a winding up commencing in respect of the collateral-provider.

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

(ii) As a general principle of HKSAR law, provided that the choice of law and court had been made in good faith and was not intended to evade the provisions of another legal system with which the Security Interest had a closer connection and provided that none of the terms of the Security Interest are contrary to HKSAR public policy (which, without giving an opinion on the matter, we do not believe would be the case), the choice of law as the law by which the Security Interest is to be governed would be upheld as a valid choice of law and court and would be applied by an HKSAR court. If proceedings were brought before the HKSAR courts in respect of the Security Interest and New York law is pleaded and proved as a fact in accordance with HKSAR procedural and evidential rules, the choice of New York law as the governing law of the Security Interest would be recognised in the HKSAR and, accordingly, New York law would govern the validity, binding effect and enforceability of the Security Interest. This general principle is subject to the exceptions set out in paragraph 2.1.2 of this Section II.

6.1.6 Application of the exceptions to the recognition of foreign law to the Security Interest

(i) It is necessary to consider whether the Security Interest comes within the scope of the exceptions set out in paragraph 2.1.2 of this Section II. For the same reasons as set out in paragraph 2.1.2 of this Section II, the exceptions described in paragraphs 2.1.2(i), (ii), (iii) and (vi) will not apply and it is the exceptions in paragraphs 2.1.2(iv) and 2.1.2(v) – that mandatory provisions of HKSAR law may override a provision of New York law and that HKSAR courts may not apply a provision of New York law that is manifestly incompatible with HKSAR public policy – that require the substantive HKSAR law analysis.

(ii) Public policy override

In respect of the exception described in paragraph 2.1.2(v) of this Section II, we do not believe that the Security Interest created under the Clearing Agreement would be manifestly incompatible with HKSAR public policy.

(iii) Mandatory provisions of HKSAR law

In respect of the exception described in paragraph 2.1.2(iv) of this Section II, HKSAR law contains certain mandatory registration requirements for "charges" registrable under Divisions 2 and 3 of Part 8 of the CO (the "**Registration Provisions**"). The basic requirement of the Registration Provisions is that, if a charge is a "specified charge" as defined in section 334 of the CO, then:

(I) "particulars" of the specified charge; and

(II) the charging instrument itself (or, in certain circumstances, a verified copy),

must be delivered to the Registrar of Companies within one month of creation (or a slightly longer period in certain circumstances). The Registrar of Companies

is a government official in the HKSAR with various statutory responsibilities relating to HKSAR Companies and foreign companies incorporated in a foreign jurisdiction but with a branch or place of business in the HKSAR. The "particulars" are to be set out on Form NM1, which is published by the Registrar of Companies.

The consequences of failure to present a specified charge to the Registrar of Companies for registration within one month of the creation of the charge are that:

(I) the charge is void against a liquidator of the company creating the charge and against any creditor of the company; and

(II) at the lender's option, the money secured by a specified charge becomes immediately payable when the charge becomes void, as described in (I) above (although how this latter consequence would apply to the Clearing Agreement is not clear).

In addition, a failure to register a specified charge is a criminal offence under the CO, rendering the company that created the charge and each of its directors and officers liable to a fine under section 337 of the CO up to the statutory maximum, which we understand is currently HK$50,000, and for continued contravention a daily default fine equal to HK$1,000 for each day during the period the charge remains unregistered.

These provisions apply to an HKSAR Company regardless of whether or not the charged property is located in the HKSAR.[66]

6.1.7 Categories of registrable charge

(i) The registration of charges provisions of the CO do not apply to all charges that may be created by a company, but only to a specified charge that falls within one of the ten categories set out in section 334 of the CO. Of these ten categories, there are only two that will, in practice, be potentially relevant to the Security Interest. These are (A) a floating charge and (B) a charge on book debts. We analyse each in turn below.

6.1.8 Floating charges

(i) A fixed charge is a charge in relation to specifically identified property that attaches to that property immediately upon creation of the charge (or, if the security provider does not yet own the property, immediately upon the security provider's acquisition of the property).[67]

[66] Section 335 of the CO. The requirements also apply to a foreign company incorporated in a foreign jurisdiction that is registered under Part 16 of the CO if the charged property is located in the HKSAR.

[67] A fixed charge is not per se registrable, although it could be registrable if it falls within one of the other categories of registrable charge (for example, a fixed charge on book debts).

(ii) The classic description of a floating charge is set out in *In re Yorkshire Woolcombers Association Ltd*[68], which reached the English House of Lords under the name *Illingworth v Houldsworth*.[69] In the latter decision, Lord Macnaghten said:

"A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp".

(iii) Accordingly, it would appear that the key characteristics of a floating charge are that it is a charge over unascertained, undefined property, and that it is of an ambulatory nature – it will fasten on the property and crystallise into a fixed charge upon the occurrence of certain events. Until crystallisation, the security provider has the right to use and dispose of the property in the ordinary course of its business.

(iv) In an important recent line of English cases, the courts have considered whether it is possible to create a fixed charge over a book debt and a floating charge over the proceeds of the book debt. The current position, established in *Agnew and Bearsley v The Commissioner of Inland Revenue* (*Re Brumark Investments Limited*)[70] is that it is not possible to separate a book debt and its proceeds for this purpose. Therefore, a charge that purports to create a fixed charge on the book debt but a floating charge on the proceeds must be construed as a floating charge.

(v) A floating charge is, however, very different from the Security Interest, which is over certain of the the Customer's contractual rights and its beneficial interest under the applicable U.S. Trust in respect of the Customer Funds and the beneficial interest in the Agent-Trust over the Customer Transactions (see paragraph 5.2 of this Section II). In respect of Customer Funds, we note from the S&C Memorandum that each Customer has a beneficial interest in all the assets comprising the Segregated Funds to the extent of its Net Liquidating Equity[71]. In respect of Customer Transactions, we note that the Customer may not put on new Customer Transactions or terminate existing Customer Transactions pursuant to the applicable Clearing Agreement without the consent of the FCM. It is evident that the Customer does not have the right to use and dispose of the charged property in the ordinary course of its business in a way which is consistent with a floating charge. It appears that the Security Interest should not be construed as a floating charge and therefore the Security Interest should not

[68] [1903] 2 Ch 284 at 295.

[69] [1904] AC 355 at 358.

[70] [2001] BCC 259.

[71] Footnotes 12 and 14 of the Summary Annex.

be subject to the registration provisions in the CO (i.e. Divisions 2 and 3 of Part 8 of the CO).

Charge over book debt

(vi) For purposes of determining whether the Security Interest might constitute a charge on book debts, we need to consider whether any collateral delivered might constitute a book debt for this purpose.

6.1.9 Book debts

(i) There is no definition of "book debt" in the CO or in any other relevant statute or regulation. The generally accepted view is that a book debt is:

(I) a debt arising out of the trading activities of the company; and

(II) that should properly be (but need not in fact have been) entered in the company's books.[72]

(ii) Debt securities given as collateral by a Customer that is not a financial institution would clearly not be commercial receivables. Where the Customer, however, is a financial institution for which securities trading is part of its general business, some commentators have suggested, while debt securities themselves may be unlikely to be book debts, dividends in respect of debt securities, might constitute book debts for purposes of section 334 of the CO.[73]

(iii) As stated in paragraph 6.1.1 of this Section II, the Security Interest is over the Customer's beneficial interest under the U.S. Trust in respect of the Customer Funds and the beneficial interest in the Agent-Trust over the Customer Transactions. While non-cash assets may, as discussed above, constitute book debts, the Customer is only securing its beneficial interest in the underlying property (as opposed to the property itself, which may be a book debt). We thus think it is highly unlikely that the Security Interest would be considered a charge over book debt and therefore the Security Interest equally should not be subject to the registration provisions in the CO (i.e. Divisions 2 and 3 of Part 8 of the CO).

6.1.10 Other perfection requirements

(i) We must also consider other perfection requirements, such as the rule in the English case of Dearle *v Hall*.[74]. This rule regulates the priority of competing assignments of a debt. Under this rule, priority goes to the first assignee to give notice to the relevant debtor of its assignment, provided, of course, that such assignee only has priority over an earlier assignee if it does not have notice of the earlier assignment. However, this rule would only apply where the applicable

[72] Following the English decisions in *Shipley v Marshall, Independent Automatic Sales Ltd v Knowles & Foster,* and *Paul & Frank Ltd v Discount Bank (Overseas) Ltd.*

[73] Roy Goode, *Legal Problems of Credit and Security*, (4th ed., 2000) page 109.

[74] (1828) 3 Russ 1; 38 ER 475 LC; [1824-34] All ER Rep 28.

charged property was held by a custodian for the security provider (i.e. the Customer). It would not apply where the charged property was held by a custodian for the secured party, which is the case here (i.e. where the charged property, namely, the rights in the Customer Funds and the Customer Transactions, is held by custodians for the FCM as secured party).

6.1.11 Post insolvency enforcement of the Security Interest

Upon an insolvency of the Customer, other than in respect of the considerations already discussed, relating to the public policy override and compliance with the Registration Provisions as set out in paragraph 6.1.9 of this Section II, the Security Interest would also be effective as against a liquidator or creditor of the Customer. For completeness, we have discussed the Registration Provisions and come to the conclusion that they should not apply.

6.2 Enforceability of the provisions permitting withdrawals for Permitted Uses and Proprietary Uses[75]

6.2.1 Enforceability pre-insolvency

Withdrawals for both Permitted Uses and Proprietary Uses, form part of the arrangements under the Clearing Agreement, in respect of which we have already discussed the exceptions in paragraph 3.6.3 of this Section II. The only additional mandatory provision of HKSAR law which needs to be considered in this context is whether the mandatory registration requirements of the Companies Ordinance (as are discussed in the context of the Security Interest in paragraph 6.1.9 of this Section II) apply to them. As discussed in paragraph 3.8.6(ii)(c) of this Section II and based on the assumptions and reasoning therein, in our view, neither Permitted Uses nor Proprietary Uses would be considered under HKSAR law as a form of security interest and so would not be subject to the mandatory security registration requirements.

6.2.2 Enforceability post-insolvency

Upon an insolvency of the Customer, it is necessary to consider whether the enforceability of the provisions permitting withdrawals for Permitted Uses and Proprietary Uses would be affected by the HKSAR insolvency principles and mandatory insolvency clawback provisions. The analysis in paragraph 4 of this Section II already considers these issues, where relevant, in respect of Permitted Uses and Proprietary Uses where they arise under a U.S. Trust.

7 Operation of the U.S. Clearing Model under HKSAR law: conclusion

On the basis of the analysis in paragraphs 3, 4 and 5 of this Section II and assuming that the Agent-Trust and Statutory Trust are valid, binding and enforceable under New York law, there is

[75] Our analysis in this paragraph 6.2 of Section II is given in respect of a U.S. Trust only. We provide no opinion regarding Permitted Uses and Proprietary Uses where the relevant U.S. Trust is not recognised as a valid trust under U.S. Federal or state law (see paragraph 1.4.2 of this Section II).

no reason[76] so far as HKSAR law is concerned why, in any action in the HKSAR courts where New York law or U.S. Federal law as the governing law of the Agent-Trust and Statutory Trust, respectively, are pleaded and proved, the Agent-Trust and Statutory Trust would not be enforceable both before and after the commencement of insolvency proceedings in respect of the Customer. As a consequence and on the assumption that New York law and U.S. Federal law so provide and subject to the assumptions, qualifications and reasoning elsewhere in this Memorandum:

(i) HKSAR law should not affect the right of the FCM as a trustee and as a contractual counterparty to the Customer to deal with the Agent-Trust Property and Statutory Property in accordance with the contractual and trust arrangements agreed (or implied) between the FCM and a Customer and/or as specified by statute, as described in the S&C Memorandum;

(ii) the assets held by the FCM in the omnibus customer positions account, the Customer Account and the Segregated Funds Account and the liabilities incurred by the FCM in the course of performing its obligations or exercising its rights under the Clearing Agreement will not be treated under HKSAR law as assets or liabilities of the Customer, but as assets and liabilities of the FCM in its capacity as principal, agent-trustee or trustee (as the case may be)[77] that (in the case of assets) are ultimately held on trust for the Customer under the terms of the Agent-Trust, and the Customer and the FCM (to the extent of the Residual Interest) under the terms of the Statutory Trust;

(iii) HKSAR law should not affect the various methods by which an FCM can bring about a Position Liquidation and Margin Liquidation, as set out in paragraphs 2.7 and 2.8 of the Summary Annex, to effect the liquidation of a Customer's Futures Transaction and Cleared Derivatives Transactions, as set out in sections III.B and III.C of the S&C Memorandum;

(iv) HKSAR law should not affect the Determination of Account, pursuant to which, following a Position Liquidation and Margin Liquidation, a single net amount is determined by the FCM after the deduction of any costs and expenses incurred in connection with the liquidation of Customer Transactions or during the course of acting as the Customer's FCM that are permitted by the segregation rules and separate account rules within an Account Class. Such single net amount is reflected in the balance of the Customer Account and represents the Net Liquidating Equity that is the Customer's net entitlement under the Clearing Agreement;

(v) HKSAR law should not affect the exercise by the FCM of its rights in respect of Permitted and Proprietary Uses; and

(vi) The Security Interest and the provisions permitting withdrawals for Permitted Uses and Proprietary Uses should be enforceable both pre- and post-insolvency of the Customer

[76] This statement is made on the assumption that Permitted and Non-Permitted Uses would not be considered under HKSAR law as a form of security interest, as to which, see our discussion in paragraphs 3.8 and 6.2 in Section II.

[77] However, we note that liabilities incurred by the FCM in its capacity as agent-trustee or trustee are not limited in recourse to the Agent-Trust Property and Statutory Property.

subject to compliance with the Registration Provisions. Iin paragraph 6 of Section II, we discuss these requirements and say that they should not apply.

III. ISSUES

In this Part III we address the questions contained in your Instructions. Each question is set out in italics followed by our response.

1 Definitions and Assumptions

1.1 The definitions for the following terms used in this Part III are below:

"**Cleared Derivatives Liquidation Rights**" means the different methods and processes (as set out in section III.B of the S&C Memorandum) by which an FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a Customer's Cleared Derivatives Transactions;

"**Event of Default**" means an event of default (whether or not described as an "event of default") contained within a Covered Base Agreement or a CDA;

"**Futures Liquidation Rights**" means the different methods and processes (as set out in section III.B of the S&C Memorandum) by which an FCM is entitled, upon the occurrence of an Event of Default, to cause the liquidation of a customer's Futures Transactions;

"**Futures Transactions**" means transactions for the purchase or sale of commodities for future delivery on, or subject to the rules of, a derivatives clearing organization registered as such under the United States Commodity Exchange Act or traded on, or subject to the rules of, a board of trade outside the United States and/or options thereon subject to Part 33 of the rules of the CFTC;

"**Liquidation Rights**" means the Cleared Derivatives Liquidation Rights and the Futures Liquidation Rights;

1.2 **Additional assumptions**

In addition to the assumptions in paragraph 6 of Section I, for the purposes of the questions in relation to Creation, Perfection and Enforcement of FCM's Security Interest in Covered Collateral (as defined below), we also assume as follows:

1.2.1 Under the terms of the Covered Agreement, the Customer grants to the FCM a first-priority security interest in, lien on and right of set-off against, all the rights and interests of the Customer in respect of the following types of property, whether at the time of the grant or thereafter existing ("**Covered Collateral**"): (1) the Customer Account (i.e., the account in the name of the Customer that is maintained by the FCM on its books and records), (2) the Covered Contracts carried in or credited to the Customer Account, (3) cash credited to or held in the Customer Account and (4) the types of securities identified below that are credited to the Customer Account and that are Located or deemed Located either (i) in the HKSAR or (ii) outside the HKSAR.

1.2.2 Covered Collateral in the form of cash is denominated in a freely convertible currency and is credited to an account (as opposed to physical notes and coins) under the "control" of the FCM for purposes of the UCC, as described in paragraph 1.41.1 of the Summary Annex.

1.2.3 Any securities provided by the Customer as Covered Collateral are held in one of the following forms, are denominated in either the currency of the HKSAR or any freely convertible currency and consist of (i) corporate debt securities whether or not the issuer is organized or located in your jurisdiction; (ii) debt securities issued by the government of the HKSAR or another jurisdiction; (iii) debt securities issued by multilateral development banks and international organizations; and (iv) equity securities whether or not the issuer is organized or located in your jurisdiction:

(i) directly held bearer securities: by this we mean 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 Covered Collateral under the Covered Agreement, held directly in this form by the FCM (that is, not held by the FCM indirectly through an intermediary (as defined below));

(ii) directly held registered securities: by this we mean securities issued in registered form and, when held by the FCM as Covered 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 securities: by this we mean securities issued in dematerialized form and, when held by the FCM as Covered 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); or

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

We note the expectation that the FCM will normally hold securities in the form of intermediated securities rather than directly in one of the three forms mentioned in (i), (ii) and (iii) above.

1.2.4 As explained in footnote 46 of the Summary Annex, when the Customer delivers margin to the FCM in the form of intermediated securities, the Customer will cause its intermediary to transfer the securities to the FCM's intermediary, which will credit them to the securities account maintained by the intermediary for the FCM, and the FCM will credit the securities to the Customer Account. As the FCM and Customer typically agree

in the Covered Agreement to treat the Customer Account as a "securities account" maintained for the Customer by the FCM as the Customer's "securities intermediary," the Customer will obtain "security entitlement(s)" to the securities when they are credited to the Customer Account (as each such term is defined under Article 8 of the UCC). The security interest granted by the Customer to the FCM is in such security entitlement(s).

1.2.5 In the case of questions 11 through 14 below, after the 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 Customer, and/or, if applicable, the FCM has designated a date to begin closing out or otherwise liquidating the Customer's open positions in Covered Contracts cleared for it as a result thereof (however, an insolvency proceeding has not been instituted).

1.2.6 In the case of questions 15 through 17 below, the Customer has become subject to insolvency proceedings in the HKSAR.

2 Position Liquidation, Margin Liquidation and Determination of Account

2.1 ***Question 1: Would the parties' agreement on governing law and submission to jurisdiction set out in each of the Base Account Agreement and CDA be given effect by a court in your jurisdiction, and what would be the consequences if they were not?***

Please see our discussion in respect of this point in paragraphs 2.2 and 3.7 of Section II above.

If the parties' agreement on the governing law and their submission to jurisdiction were not upheld (although we believe it would), the Base Account Agreement and CDA would be examined on the basis of the law determined to be most applicable by an HKSAR court.

2.2 ***Question 2: 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 2.5 of the Summary Annex be recognized and upheld by a court in your jurisdiction? If a particular Position Liquidation method would either not be upheld or could be challenged, please provide further detail and explain the reason for this. Are there any circumstances in your jurisdiction, including any moratorium, stay, freeze or other consequence of the commencement of an insolvency proceeding, that might affect the FCM's ability to exercise Position Liquidation?***

Yes, subject to and as discussed in Section II above, on the basis that the Agent-Trust and U.S. Trust would be recognised under HKSAR law as trusts and New York law (in the case of the Agent-Trust) or U.S. Federal law (in the case of the Statutory Arrangements) would govern the validity, interpretation and effect of the trusts, the Position Liquidation methods set out in Section XI of the S&C Memorandum and paragraph 2.5 of the Summary Annex would be recognised and upheld by the HKSAR courts.

2.3 ***Question 3: Would the Margin Liquidation provisions of each of the Base Account Agreement and CDA be enforceable under the laws of your jurisdiction and the FCM's Margin Liquidation in respect of each Account Class be recognized and upheld by a court***

in your jurisdiction? Are there any 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 Margin Liquidation?

As set out in paragraph 2.2 of Section II (and subject to the discussion in paragraph 4 of Section II), there is no reason so far as HKSAR law is concerned why, in any action in the HKSAR courts where U.S. Federal law as the governing law of the Statutory Arrangement(s) in the form of a U.S. Trust is pleaded and proved, the efficacy of such Statutory Arrangement(s) would not be recognised both before and after the commencement of insolvency proceedings in respect of the Customer, including in respect of the enforceability of the Margin Liquidation provisions, Permitted Uses Rights and the operation of the Determination of Account.

2.4 ***Question 4: 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 (a) each Account Class and (b) all Account Classes on a combined basis be recognized and upheld by a court in your jurisdiction? Are there any 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 a Determination of Account in respect of an Account Class or the overall Customer Account (comprising the three Account Classes)?***

See the response to Question 3 above.

2.5 ***Question 5: Assuming the parties have entered into the Covered Agreement, an Event of Default has occurred with respect to the Customer 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:***

(a) Outside the context of insolvency proceedings, 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?

(b) Can a claim for the cash balance or net termination amount be proved (i.e., filed) in insolvency proceedings in your jurisdiction without conversion into the local currency?

If in either case the claim must be converted to local currency for purposes of enforcement or proof in insolvency proceedings, please set out the rules governing the timing and exchange rate for such conversion.

Please see our discussion on this point in paragraph 4.3 of Section II above.

2.6 ***Question 6: Are there any other local 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?***

No, subject to the discussion set out in Section II above.

As discussed in paragraph 6.1.11 of Section II above, there is no general prohibition on a creditor enforcing its security over the assets of a company in an HKSAR liquidation, and this would also apply in respect of the exercise of Position Liquidation, Margin Liquidation or a Determination of Account.

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

Please refer to the additional assumptions in paragraph 1.2 of this Part III.

3.1 ***Question 1: Under the laws of your jurisdiction, what law governs the contractual aspects of the security interest in the Customer's rights and interests in respect of the various types of Collateral? Would the courts of your jurisdiction recognize the validity of a security interest created under the Covered Agreement, assuming it is valid under New York law (as the governing law of the Covered Agreement)?***

3.1.1 Under HKSAR law, the law governing the contractual aspects of a security interest as a matter of contract by an HKSAR incorporated counterparty in the various forms of Covered Collateral identified is the governing law of the applicable security document, namely the Customer Agreement.

3.1.2 Assuming that the choice of law in the Customer Agreement is a valid and proper choice of law, the HKSAR courts would recognize the validity of a security interest created under such document if that security interest was valid under the governing law of such document. See discussion in paragraph 6.1.5 of Section II.

3.2 ***Question 2: Under the laws of your jurisdiction, what law governs the proprietary aspects of the security interest in the Customer's rights and interests in respect of the different types of Collateral (i.e., the formalities required to protect the security interest against competing claims) granted by the Customer (for example, the law of the jurisdiction of incorporation or organization of the Customer, the jurisdiction where the Collateral is Located (or deemed Located), the jurisdiction of the location of the FCM's intermediary or the jurisdiction of the location of the FCM as the Customer's securities intermediary, in relation to Collateral in the form of intermediated securities)? What factors would be relevant to this question? If the Location (or deemed Location) of the Collateral is the determining factor, please briefly describe the principles governing such determination under the law of your jurisdiction with respect to the different types of Collateral. If relevant, please describe how the laws of your jurisdiction apply to each form in which securities Collateral may be held as described in Additional Assumption II.B.3 in the Instructions.***

3.2.1 Under HKSAR rules of private international law, the relevant law governing the proprietary aspects of a security interest (including perfection and other formalities required to protect a security interest in the Covered Collateral against competing claims) is the *lex situs*. [78]

[78] *Dicey, Morris & Collins on the Conflict of Laws* (fifteenth edition 2012), chapter 24.

3.2.2 Please refer to paragraph 5.4 of Section II where we discuss the *lex situs* of the Covered Collateral which is the subject of the Security Interest.

3.3 ***Question 3: Would the courts of your jurisdiction recognize a security interest in the Customer's rights and interests in respect of the different types of Collateral? In answering this question, please bear in mind the different forms in which securities Collateral may be held, as described in the Additional Assumption II.B.3 in the Instructions. Please indicate, in relation to cash Collateral, if your answer depends on the Location (or deemed Location) of the Customer Account or the account in which the relevant deposit obligations are recorded and/or upon the currency of those obligations.***

Assuming that the choice of law in the Customer Agreement is a valid and proper choice of law, the HKSAR courts would recognize the validity of a security interest created under such document if that security interest was valid under the governing law of such document. See the discussion in paragraphs 5.1 - 5.4 of Section II.

3.4 ***Question 4: What is the effect, if any, under the laws of your jurisdiction of the fact that the amount secured or the amount of the Collateral subject to the security interest will fluctuate under the Covered Agreement (including as a result of establishing open positions in 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 Collateral (i.e., cash and securities Collateral not yet delivered to the FCM and open positions not yet established in Covered Contracts at the time of entry into the Covered Agreement)?

(c) Is there any difficulty with the concept of creating the 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 Customer with the FCM?

(d) Is it necessary under the laws of your jurisdiction for the amount secured by the security interest to be a fixed amount or subject to a fixed maximum amount?

(e) Is it permissible under the laws of your jurisdiction for the FCM to hold Collateral in excess of its actual exposure to the Customer under the Covered Agreement?

In relation to (a), it is understood that the security interest in the Customer's rights and interests in respect of any specific Collateral would only be relevant in relation to future obligations, if ever, at the time such future obligations arise and then only in relation to Collateral held at that time. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the security interest as security for such obligations or whether the security interest would take effect in relation to those future obligations without further action by either party.

In relation to (b), it is understood that the security interest in the Customer's rights and interests in respect of the different types of Collateral to be delivered at some point in the

future after the time of entry into the Covered Agreement would not take effect in relation to such Collateral until it had been delivered to the FCM in accordance with the Covered Agreement. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the security interest in the Customer's rights and interests in respect of such Collateral or whether the security interest in relation to the Customer's rights and interests in respect of such Collateral would take effect without further action (other than the delivery) by either party.

In relation to (c), you may assume that each specific delivery to the FCM and return by the FCM of Collateral consisting of cash or securities under the Covered Agreement from time to time would be properly recorded by the FCM, so that, while the pool of Collateral would change from time to time, at any specific time the composition of the pool of Collateral could be clearly identified by the FCM.

3.4.1 As a matter of HKSAR law, there are no adverse consequences arising from the fact that the amount secured or the amount of Covered Collateral subject to the security interest will fluctuate under the Covered Agreement provided it does so in accordance with the terms agreed between the parties.

3.4.2 Subject to the foregoing, in answer to the specific questions on this point:

(i) Yes, provided that the future obligations are able to be identified with certainty as and when they arise, by reference to the terms of the Covered Agreement (which will include future obligations of the Customer).

(ii) Yes, provided the future Covered Collateral is able to be ascertained as and when it is provided as Covered Collateral.

(iii) No, provided the pool of assets over which the security interest to be created is identified with sufficient clarity to identify the Covered Collateral at any given time.

(iv) No.

(v) Yes, provided it has been agreed by the parties that such excess Covered Collateral may be held.

3.5 ***Question 5: Assuming that the courts of your jurisdiction would recognize the security interest in the Customer's rights and interests in respect of each type of Collateral, is any action (filing, registration, notification, stamping, notarization or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) required in your jurisdiction to perfect the security interest? If so, please indicate what actions must be taken and how such actions may differ, if at all, depending upon the type of Collateral in question.***

Please refer to the discussion in paragraph 6.1.7 - 6.1.9 of Section II (regarding registration of charges and other perfection requirements).

3.6 ***Question 6: If there are any other requirements to ensure the validity or perfection of the security interest in the Customer's rights and interests in respect of each type of***

Collateral, please indicate the nature of such requirements. For example, is it necessary as a matter of formal validity that the Covered Agreement be expressly governed by the law of your jurisdiction or translated into any other language or for the Covered Agreement to include any specific wording? Are there any other documentary formalities that must be observed in order for the security interest in the Customer's rights and interests in respect of any type of Collateral to be recognized as valid and perfected in your jurisdiction?

Subject to our response to Question 5, there are no particular additional requirements or formalities to ensure the validity or perfection of a security interest in relation to each type of Covered Collateral that may be delivered under a Covered Agreement. It is not necessary as a matter of formal validity that a Covered Agreement be expressed to be governed by HKSAR law. As the Covered Agreement is drafted in the English language, one of the two official languages of the HKSAR, the question of translation does not arise. No specific form of words is necessary to create a security interest under HKSAR law as long as the intention to create a security interest is clear from the terms of the document and other relevant circumstances. The Covered Agreement is sufficiently clear in this regard.

3.7 ***Question 7: Assuming that the FCM has obtained a valid and perfected security interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions 1 through 6 above, as applicable, will the FCM or the 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 Collateral transferred from time to time when required pursuant to the Covered Agreement?***

No additional actions of this kind will be required.

3.8 ***Question 8: Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the validity and/or perfection of a security interest in the Customer's rights and interests in respect of any type of Collateral (e.g., because the Collateral is Located or deemed Located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected security interest in the Collateral under the laws of such other jurisdiction, will the FCM have a valid security interest in the Collateral so far as the laws of your jurisdiction are concerned? Is any action (filing, registration, notification, stamping or notarization or any other action or the obtaining or any governmental, judicial, regulatory or other order, consent or approval) required under the laws of your jurisdiction to establish, perfect, continue or enforce the security interest? Are there any other requirements of the type referred to in question 6 above?***

Please see our discussion on this point in paragraphs 5 and 6 of Section II above.

3.9 ***Question 9: Are there any particular duties, obligations or limitations imposed on the FCM in relation to the care of the Collateral held by it pursuant to the security interest?***

Under HKSAR law, the FCM is under an obligation established by case law to take reasonable steps to ensure the safe custody of any charged property in its possession.

3.10 ***Question 10: Do the laws of your jurisdiction recognize the right of the FCM to use cash or securities Collateral (as described in Additional Assumptions II.B.2 and II.B.3 in the Instructions) pursuant to an agreement with the Customer? In particular, how does such use of the Collateral affect, if at all, the validity, continuity, perfection or priority of the 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 such Collateral under the laws of your jurisdiction?***

Please see discussion in paragraph 3.8.6(ii)(c) of Section II on Permitted Uses and Proprietary Uses.

3.11 ***Question 11: Assuming that the FCM has obtained a valid and perfected security interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions 1 through 6 above, as applicable, what are the formalities (including the necessity to obtain a court order or conduct an auction), notification requirements (to the Customer or any other person) or other procedures, if any, that the FCM must observe or undertake in enforcing its security interest as a secured party under the Covered Agreement? For example, is it free to sell the Collateral (including to itself) and apply the proceeds to satisfy the Customer's outstanding obligations under the Covered Agreement? Do such formalities or procedures differ depending on the type of Collateral involved?***

3.11.1 There are four principal remedies for a mortgagee under HKSAR law. These are sale of the secured property, the appointment of a receiver, taking possession, and foreclosure. Of these, a mere chargee (that is, a holder of a charge that does not also constitute a mortgage) has only the remedies of sale of the secured property and appointment of a receiver.

3.11.2 Of these, in a financial markets context, the power of sale is the remedy typically exercised by a mortgagee or chargee in relation to Covered Collateral in the form of securities. The appointment of a receiver is generally not thought to confer any practical advantage in this context, and the mortgagee or chargee typically already has possession of the relevant securities (as would normally be the case under the Covered Agreement).

3.11.3 Foreclosure is the process under which the mortgagor's equitable right to redeem the mortgaged property is declared by the court to be extinguished or destroyed and the mortgagee is left as owner of the property both at law and in equity (subject only to prior encumbrances). The mortgagee is then free to sell the property or to retain title to it. Foreclosure is always an act of court, and a mortgagee cannot foreclose and keep the assets for itself without a court order.[79] For this reason, it is considered too time-consuming and cumbersome to be a practical remedy in the context of a financial market security arrangement of the type exemplified by the Covered Agreement. In addition, in certain circumstances, the court may reopen the foreclosure order, restoring the

[79] See the English case of *Re Farnol Eades Irvine & Co.* [1915] 1 Ch 22.

mortgagor's equitable right to redeem. For these reasons, foreclosure is rarely, if ever, used by a mortgagee of securities.

3.11.4 Accordingly, the exercise by the FCM of its rights contemplated by the Covered Agreement, including the right to "liquidate" the Covered Collateral by selling it, is permitted by HKSAR law. It is not necessary for any particular formalities to be followed by the FCM in exercising its right of sale. Accordingly, the FCM may on enforcement of the applicable document sell the Covered Collateral.

3.11.5 In particular, a court order or auction is not required and notice of sale need not be given to the Customer, although in practice secured creditors do often give a short period of notice before selling Covered Collateral. This does not differ depending on the type of Covered Collateral involved.

3.11.6 In exercising its power of sale, the FCM is subject to a duty to take reasonable care to obtain the best price reasonably available at the time.[80] This will normally be the current market value of the Covered Collateral comprising securities.[81]

3.11.7 A FCM may not sell posted Covered Collateral to itself, either alone or with others, unless the sale is made by the court and the FCM has obtained leave to bid. This is because such a transaction would amount to foreclosure without the leave of the court. In addition, there is a broader policy basis for the rule, which is that a person should not put himself in a position where his duty (in this case, to obtain the best price reasonably available) and his interest (in this case, to pay as low a price as possible) conflict.[82]

It is established that a mortgagee may sell mortgaged property to a company in which the mortgagee has an interest, provided that it can prove that the sale was in good faith and that it had taken reasonable steps to obtain the best price reasonably obtainable at that time.[83] *A fortiori*, a mortgagee may sell mortgaged property to an affiliated company, subject to the same proviso.

3.12 ***Question 12: Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the validity and/or perfection of a security interest in the***

[80] See the English case of *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949; 2 All ER 633. See also discussion of this issue in *Fisher and Lightwood's Law of Mortgage* (fifteenth edition 2019) at paragraph 30.23 and the cases cited there. A recent HKSAR Court of First Instance case *Indian Overseas Bank V Seabulk Systems Inc and others* [2018] HKCU 295, has also applied the test in *Cuckmere Brick Co Ltd v Mutual Finance Ltd* to determine if a secured party has fulfilled its duty to take reasonable care in exercising its power of sale.

[81] *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295, Privy Council (appeal from the New Zealand Court of Appeal).

[82] Some of the case law appears to be based on the argument that a mortgagee cannot sell to itself, for the reason that "[a] sale by a person to himself is no sale at all". *Obiter dictum* of Lindley LJ in the English case of *Farrar v Farrars Ltd* (1888) 40 ChD 395 at 409. This is, strictly speaking, a nonsensical argument as the mortgagee would simply be selling the equity of redemption to itself as agent for, and therefore on behalf of, the mortgagor. There is no objection to a mortgagor and mortgagee contracting, in an agreement separate and independent from the mortgage, for the mortgagee to purchase the mortgagor's equity of redemption (see the English cases of *Spurgeon v Collier* (1758) 28 ER 605; *Reeve v Lisle* [1902] AC 461, HL; and *Alec Lobb (Garages) Ltd v Total Oil GB Ltd* [1983] 1 All ER 944, per Millett QC at 963, 965). This could not happen if such a sale constituted a sale by a person to itself. The true basis of the rule, as noted in the text in that footnote, is that a sale by a mortgagee to itself pursuant to its power of sale under the mortgage is, in effect, a foreclosure without authority of the court. It also offends the broader policy against self-dealing by a fiduciary.

[83] *Farrar v Farrars Ltd* (1888) 40 Ch D 395; *Tse Kwong Lam v Wong Chit Sen* [1983] 3 All ER 54.

Customer's rights and interests in respect of any Collateral (e.g., because such Collateral is Located or deemed Located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected security interests under the laws of such other jurisdiction, are there any formalities, notification requirements or other procedures, if any, that the FCM must observe or undertake in your jurisdiction in exercising its rights as a secured party under the Covered Agreement?

There are no other requirements apart from what is considered above.

3.13 ***Question 13: Are there any laws or regulations in your jurisdiction that would limit or distinguish a creditor's enforcement rights with respect to the security interest in the Customer's rights and interests in respect of any type of 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 the security interest?***

In relation to entities of the kind covered by this Memorandum, there are no rules or regulations of the kind mentioned in clause (a), (b) or (c) of this question, although as mentioned in the preamble to this Memorandum certain restrictions may apply in relation to other types of entities, particularly in relation to their power to enter into particular transactions and the assets of those entities available to satisfy particular kinds of obligations. The types of Covered Collateral involved should not have any effect on enforcement rights. There are no "statutory liens" or preferred claims in relation to a fixed charge over Covered Collateral of the kind under review.

3.14 ***Question 14: How would your response to questions 11 through 13 above change, if at all, assuming that an insolvency proceeding above 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 Customer (for example, would this affect this ability of the FCM to enforce its security interest in the Customer's rights and interests in the Collateral)?***

If an insolvency proceeding above has occurred with respect to the FCM, the FCM will be able to exercise its enforcement rights if there is also an event of default subsisting in relation to the Customer. In any other case, the FCM may not enforce its security.

3.15 ***Question 15: How are competing priorities between creditors determined in your jurisdiction? What conditions must be satisfied if the FCM's security interest in the Customer's rights and interests in each type of Collateral is to have priority over all other claims (secured or unsecured) of an interest in the Collateral?***

3.15.1 The HKSAR law rules relating to priorities between creditors are complex, but the basic general principles are as follows:

(i) Secured claims take precedence over unsecured claims (except certain statutorily preferred claims).

(ii) Secured claims of the same nature over real or tangible property typically take priority in the order in which the security interest was created as a matter of common law. Secured claims over choses in action take priority in the order in

which notice of the relevant interest is given to the debtor/obligor, following the rule in *Dearle v Hall*.

(iii) In relation to real or tangible property, where there is a competition between, for example, a "legal" mortgage and an "equitable" mortgage, the legal mortgage will take precedence over the equitable mortgage irrespective of the time of creation, provided that the legal mortgage was taken for value without knowledge of the equitable mortgage and subject also to any registration requirements as discussed in the answer to Question 5 in this Section III. Put briefly, a "legal" mortgage, in this context, is one where the FCM has a mortgage coupled with a perfected transfer of the legal title to the Covered Collateral (for example, it is registered as the owner of Covered Collateral in the form of registered securities), while an "equitable" mortgage, in this context, is typically one where the FCM has a mortgage without legal title to the Covered Collateral, such as a situation where the registered shares continue to be held in the name of the Covered Customer.

3.15.2 The principles in paragraph 3.15.1 are not exhaustive and only set out the broad categories of priority rules. Different classes of assets may be subject to different priority rules.

3.15.3 For the FCM's security interest to have priority over all other claims (secured or unsecured), the FCM will need to have obtained a security interest in the relevant Covered Collateral prior to any other security interest or other adverse third party rights being created (or without knowledge of other equitable interests if the FCM obtains a legal security interest) and, where relevant, the security interest will have been registered in accordance with the provisions of the CO discussed in paragraphs 6.1.7- 6.1.9 of Section II.

3.15.4 To protect against the possibility of the FCM's security interest being defeated by a subsequent legal interest taken without knowledge of the FCM's interest, the FCM should wherever possible obtain a "legal" security interest, by taking legal title.

3.16 ***Question 16: Would the FCM's enforcement of its security interest in the Customer's rights and interests in any type of Collateral be subject to any stay, moratorium or freeze or otherwise be affected by commencement of the insolvency?***

3.16.1 Section 264 of the C(WUMP)O applies the rules relating to bankruptcy in the HKSAR to the winding-up of an insolvent company.

3.16.2 In addition, certain additional considerations apply to HKSAR Companies that are holding companies of within scope financial institutions or "affiliated operational entities" of such financial institutions. These issues are as discussed in paragraph 4.4 of this Section III.

3.17 ***Question 17: Will the Customer (or its administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official) be able to recover any transfers of 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 a transfer constituting a***

"preference," fraudulent transfer or transaction at an undervalue (however called and whether or not fraudulent) in favor of the FCM or on any other basis? If so, how long before the insolvency does this suspect period begin? Would the posting of additional margin (which could be required when the Customer Account's net liquidating equity has fallen below the required margin level for the Customer Account due to trading losses in respect of one or more Covered Contracts cleared for the Customer) during the suspect period be subject to avoidance, either because the Collateral was considered to relate to an antecedent or pre-existing obligation or for some other reason?

See discussion on the insolvency clawback provisions in paragraph 4.1.8 of Section II.

3.18 ***Question 18: If relevant in your jurisdiction, please analyze whether or not the Covered Agreement, and the collateral arrangements contemplated thereby, would constitute a financial collateral arrangement under the local implementation of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.***

Not applicable for the HKSAR.

3.19 ***Question 19: Are there any other local law considerations that you would recommend the FCM to consider in connection with enforcing its security interest in the Customer's rights and interests in respect of any Collateral?***

There are no other requirements apart from what is considered above.

3.20 ***Question 20: Are there any other circumstances you can foresee that might affect the FCM's ability to enforce its security interest in the Customer's rights and interests in respect of Collateral in your jurisdiction?***

We do not know of other considerations.

4 Qualifications and reliance

4.1 Qualifications

4.2 We express no opinion on any provision of the Clearing Agreement or any provision set out in the Summary Annex save for those provisions that we expressly opine upon in this Memorandum.

4.3 The term "enforceable" as used in this Memorandum means that the obligations assumed by the relevant party under the relevant document are of a type which the HKSAR courts enforce.

4.4 It does not mean that those obligations will necessarily be enforced in all circumstances in accordance with their terms.

4.5 Enforcement may be limited by general principles of equity – for example, equitable remedies may not be available where damages are considered to be an adequate remedy.

4.6 The enforcement in the HKSAR of the relevant Clearing Agreement (or the DCO rules that it is subject to) will be subject to Hong Kong rules of civil procedure.

4.7 The enforcement of the relevant Clearing Agreement (or the DCO rules that it is subject to) may be limited by frustration.

4.8 An HKSAR court may refuse to give effect to any contractual provision concerning payment of the costs of enforcement or litigation brought before an HKSAR court.

4.9 We have not reviewed any of the terms of the Transactions entered into, or to be entered into, between the FCM, the Customer and the DCO (or Foreign Futures Broker) and express no opinion on them.

4.10 The analysis in this Memorandum is restricted to the position where the relevant insolvency proceedings in respect of the Customer are governed by HKSAR law. We express no opinion as to whether HKSAR law would, in fact, govern such proceedings, whether or not conducted in the HKSAR courts.

4.11 Claims may become barred under the Limitation Ordinance (Cap. 347) or may be or become subject to set-off or counterclaim.

4.12 We are not qualified to give, and have not given, accounting or auditing advice and nothing in this Memorandum is to be interpreted otherwise.

4.13 A certificate, determination, valuation, notification, opinion or the like might be held by the HKSAR courts not to be conclusive, final or binding if it could be shown to have an unreasonable or arbitrary basis or in the event of manifest error despite any provision in the relevant Clearing Agreement (or the DCO rules or clearing agreement between the FCM and the Foreign Futures Broker that it is subject to) to the contrary.

4.14 Any provision of the relevant Clearing Agreement (or the DCO rules or clearing agreement between the FCM and the Foreign Futures Broker that it is subject to) which constitutes, or purports to constitute, a restriction on the exercise of any statutory power may be ineffective.

4.15 The effectiveness of terms exculpating a party from a liability or from a duty otherwise owed may be limited by law or regulation provided that any relevant law or regulation under HKSAR law is covered and has been discussed in this Memorandum.

4.16 Any provision of the relevant Clearing Agreement (or the DCO rules or clearing agreement between the FCM and the Foreign Futures Broker that it is subject to) stating that a failure or delay on the part of any party in exercising any right or remedy shall not operate as a waiver of such right or remedy may not be effective.

4.17 Any prohibition of bringing, instituting or joining insolvency proceedings in relation to any party is subject to the following qualifications:

4.18 it is possible that an HKSAR court would deal with an insolvency proceeding even if it had been presented in breach of contract; and

4.19 there may be no entitlement to damages as a result of such breach (as such insolvency proceeding may not itself be the cause of the relevant loss).

4.20 We do not express any opinion as to any taxation matters.

4.21 An HKSAR court may, or may be required to, stay proceedings or decline jurisdiction in certain circumstances - for example, if proceedings are brought elsewhere.

4.22 This Memorandum is subject to the provisions of the Resolution Ordinance and secondary legislation, regulations, instruments and orders made, or which may be made, under it.[84] The Monetary Authority, the Insurance Authority and the Securities and Futures Commission[85] (the "**Resolution Authorities**") have wide-ranging powers to resolve a "within scope financial institution", a "holding company" of a within scope financial institution or an "affiliated operational entity" of a within scope financial institution (each as defined in the Resolution Ordinance). "Within scope financial institutions" are a "banking sector entity", an "insurance sector entity" and a "securities and futures sector entity".[86] A party's ability to terminate its contractual arrangements with a within scope financial institutions which is subject to an exercise of one of the Stabilization Options (as defined below), or action taken thereunder. These restrictions are as follows:

4.22.1 If a within scope financial institution ceases to be viable, Part 5 of the Resolution Ordinance provides for five stabilization options (the "**Stabilization Options**") that a Resolution Authority may apply in resolving that within scope financial institution (in addition to other powers discussed below). These are:

(a) transfer of some or all of the business of the applicable institution to a purchaser;

(b) transfer of some or all of the business of the applicable institution to a bridge institution;

(c) transfer of the applicable institution's assets, rights and liabilities to an asset management vehicle;

(d) bail-in of the applicable institution by modifying or cancelling certain liabilities to absorb and losses and provide capital to the institution;

(e) transfer the applicable institution to a temporary public ownership ("**TPO**") company.

Protections on partial property transfers

[84] The Resolution Ordinance as well as the Financial Institutions (Resolution) (Protected Arrangements) Regulation (Cap. 628A) (the "Protected Arrangements Regulation") came into force on 7 July 2017, except for Part 8 (Clawback of Remuneration), section 192 (Notice of intention to present winding up petition to resolution authority) and Division 10 (Amendments to Insurance Companies (Amendment) Ordinance 2015 (12 of 2015)) of Part 15. See the Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 (L.N. 77 of 2017).

[85] The Financial Secretary may designate a lead resolution authority for cross-sectoral groups.

[86] In broad terms, banking sector entities include HKSAR- and overseas-incorporated authorized institutions and designated clearing and settlement systems under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584). Insurance sector entities include authorized insurers under the Insurance Companies Ordinance (Cap. 41) which are or which belong to groups containing global systemically important insurers on the list published by the Financial Stability Board (FSB). Securities and futures sector entity include licensed corporations ("**LCs**") that is a non-bank non-insurer global systemically important financial institution ("**NBNI G-SIFI**") or belongs to a NBNI G-SIFI group; a LC that is a branch or subsidiary of an entity in a global systemically important bank group or a global systemically important insurer group; a recognized clearing house under the SFO or a recognized exchange company under the SFO if the Financial Secretary so designates.

4.22.2 Subject to certain limitations, and as noted in paragraph 4.22.1, certain Stabilization Options permit a Resolution Authority to transfer all or part of the assets, rights and/or liabilities of the relevant financial institution to another entity. Such assets, rights and/or liabilities could include property outside the HKSAR which are governed by non-HKSAR law.[87] However, in order to avoid the otherwise inequitable results on a partial transfer, particularly as regards the possibility of impairing netting arrangements, extensive protection is given to such arrangements by the Resolution Ordinance and the Financial Institutions (Resolution) (Protected Arrangements) Regulation (Cap. 628A) (the "**Protected Arrangements Regulation**").

4.22.3 In particular, section 6 of the Protected Arrangements Regulation provides that a Resolution Authority, in making a "regulated Part 5 instrument"[88] that transfers assets, rights and liabilities of an entity against which a liability is secured under a secured arrangement,[89] is to seek to not (i) transfer those assets or rights unless the liability and the benefit of the security are also transferred under that instrument, (ii) transfer those assets or rights unless the liability and the benefit of the security are also transferred under that instrument or (iii) transfer the liability unless the benefit of the security is also transferred under that instrument.[90] Accordingly, in our opinion, the liabilities of the Customer would not be split from the assets over which the Security Interest is created in favour of the FCM under a partial property transfer.

Protections in the event of a bail-in

4.22.4 Section 58 of the Resolution Ordinance provides that a Resolution Authority may make one or more bail-in instruments in respect of a within scope financial institution (providing for the cancellation, modification or change in form[91] of liabilities owed by the relevant financial institution) with the objective of absorbing losses incurred, or reasonable expected to be incurred, by the relevant entity.

4.22.5 However, the power to make a bail-in provision pursuant to section 58 cannot be exercised in respect of any "excluded liabilities",[92] including, amongst other things, any liability, so far as it is secured.[93] In our opinion, the liabilities of the Customer to the FCM under the Clearing Agreement will be excluded because they are secured liabilities as a result of the Security Interest.

Impact on Winding up

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87 Section 9 of the Protected Arrangements Regulation.

88 A securities transfer instrument, a property transfer instrument or a bail-in instrument that (a) results in a partial property transfer being effected or (b) contains a bail-in provision: sections 2(1) and 74 of the Resolution Ordinance.

89 A "secured arrangement" means an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another.

90 Section 6 of the Protected Arrangements Regulation.

91 Including converting an instrument from one form or class to another form or class, replacing an instrument with another instrument of any form or class, creating a new security of any form or class, and converting such liabilities into securities issued by a bridge institution or a holding company of the financial institution: section 58(5) of the Resolution Ordinance.

92 Sections 58(4) and (9) of the Resolution Ordinance.

93 Section 2(l), Schedule 5 of the Resolution Ordinance.

4.22.6 The Resolution Ordinance may have an impact on how a winding up of a within scope financial institution can be commenced.

4.22.7 If a within scope financial institution provides certain services essential to the continued performance of critical financial functions in the HKSAR, and that within scope financial institution is in resolution,[94] the Resolution Authority may issue a notice in writing[95] directing that within scope financial institution to continue to provide such functions. The service of such a notice does not prevent the commencement or continuation of winding up proceedings in respect of such financial institution but such winding up proceedings may not be concluded while the notice is in force.[96] If the liquidator wishes to conclude the winding up, it can serve a notice on the Resolution Authority. Six months after the service of such notice, the notice served by the Resolution Authority will expire and the winding up can conclude.

4.22.8 Winding up proceedings may not be commenced in respect of a within scope financial institution or its holding company to which the bail-in stabilisation option has been applied[97] or a non-HKSAR resolution action which has been recognized in the HKSAR by way of a recognition instrument.

4.22.9 We note that section 192 of the Resolution Ordinance is not yet in effect but provides that a petition for winding up by the HKSAR Court may not be presented in respect of a within scope financial institution or its holding company unless the petitioner has given written notice to the resolution authority and the resolution authority has either not objected within seven days or has informed the petitioner that it does not intend to initiate resolution of the financial institution or its holding company within such seven day period.[98] The petitioner then has a 14 day period to present the petition.

Disapplication of certain default event provisions

4.22.10 Pursuant to section 89 of the Resolution Ordinance, a "crisis prevention measure"[99] taken in relation to a within scope financial institution or a group company of a within scope financial institution[100] or the occurrence of an event directly linked to the taking of such a measure, will not itself trigger a "default event provision"[101] under a contract of

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[94] The Resolution Authority may issue the notice in writing in the situation where the rights and liabilities of that within scope financial institution have been transferred to a purchaser, bridge institution or asset management vehicle; section 79 of the Resolution Ordinance.

[95] Served pursuant to section 79(3) of the Resolution Ordinance.

[96] Section 80 of the Resolution Ordinance.

[97] But where certain bail in provisions have not yet been fully implemented.

[98] Section 192 of the Resolution Ordinance.

[99] The exercise in respect of a "qualifying entity" by a resolution authority of any of its power under Part 3, 5 or 13 or Division 2 of Part 4 of the Resolution Ordinance: section 86 of the Resolution Ordinance. The powers under Part 3 include powers to remove any impediments to the orderly resolution of a within scope financial institution or its holding company in accordance with its resolution plan; the power to make capital reduction instruments that make provision for write off or conversions of certain securities issued by the financial institution; and the exercise by the Resolution Authority of its powers to make one of the stabilisation options.

[100] As "qualifying entities": sections 86 and 87 of the Resolution Ordinance.

[101] Defined in section 86 of the Resolution Ordinance as a provision of a contract that:

(a) has the effect that if a specified event occurs or a specified situation arises:

that qualifying entity or an entity that is a member of the same group of companies provided that the substantive obligations provided for in the contract (including payment and delivery obligations) continue to be performed.[102]

Suspension of obligations

4.22.11 A Resolution Authority of a within scope financial institution may, subject to certain exceptions, suspend for a specified period the payment or delivery obligations under a contract to which the within scope financial institution, or a subsidiary of such financial institution, is a party.[103]

4.22.12 Such a suspension begins when the instrument providing for the suspension is published and ends at the expiry of the business day following the day on which such instrument is published. During that period, creditors may not, without the written consent of the resolution authority, take action to attach the assets of or obtain the payment of money or delivery of property by the within scope financial institution. The obligation is treated as falling due after the period of suspension.

4.22.13 However, as noted in paragraph 4.22.11, this power does not apply to any "excluded obligation",[104] which includes, amongst other things, an obligation to pay the whole or any part of a deposit protected under the Deposit Protection Scheme Ordinance (Cap.

(i) the contract is terminated, modified or replaced;
(ii) rights or obligations under the contract are extinguished, suspended, modified or replaced;
(iii) a right accrues to terminate, modify or replace the contract;
(iv) a right accrues to extinguish, suspend, modify or replace rights or obligations under the contract;
(v) a right accrues to accelerate, close out, set off or net obligations under the contract;
(vi) a right accrues to prevent a duty from arising under the contract;
(vii) a sum becomes payable or ceases to be payable;
(viii) delivery of anything becomes due or ceases to be due;
(ix) a right to claim a payment or delivery accrues, changes or lapses;
(x) any other right accrues, changes or lapses; or
(xi) an interest is created, changes or lapses; or

(b) has the effect that a provision of the contract:
(i) only takes effect if a specified event occurs or does not occur;
(ii) only takes effect if a specified situation arises or does not arise;
(iii) only has effect for so long as a specified event does not occur;
(iv) only has effect while a specified situation lasts;
(v) applies differently if a specified event occurs;
(vi) applies differently if a specified situation arises; or
(vii) applies differently while a specified situation lasts.

[102] Section 89 of the Resolution Ordinance does not contain any specific exceptions in respect of recognized clearing houses or financial market infrastructures generally.

[103] Section 83 of the Resolution Ordinance.

[104] Subsections (6) and (7) of sections 83 and 84 of the Resolution Ordinance.

581) an obligation of a financial institution in relation to its participation, whether directly or indirectly, in a "financial market infrastructure".[105]

Suspension of termination rights

4.22.14 Section 90 of the Resolution Ordinance gives Resolution Authorities the power to suspend for a specified period any "termination right"[106] of a counterparty to a qualifying contract.[107] Any such suspension would begin when the instrument providing for the suspension is first published and end no later than the end of the first business day following the day on which that instrument is published.

4.22.15 The stay applies to all qualifying contracts with the within scope financial institution or group companies of the within scope financial institution. If this power is exercised, the termination and liquidation provisions under the Clearing Agreement would fall within the scope of these suspension and stay provisions, with the result that the FCM would not normally be able to exercise its rights under the Clearing Agreement before the end of the suspension.

4.22.16 Certain exemptions apply, namely:

(i) if the counterparty has been notified in writing that the contract will not be transferred and that bail-in will not apply;

(ii) where the termination right has been triggered otherwise than by a crisis prevention measure[108] in respect of the counterparty or its group company or the occurrence of an event linked to the taking of such measure, that is, if the entity in question or its holding company fails to perform its obligations for payment and delivery or the provision of collateral.

4.22.17 In particular, qualifying contracts that a counterparty or its group company has with a financial market infrastructure are exempt from the stay.

Non-HKSAR resolution actions

4.22.18 Resolution actions or reorganisation measures taken, or bail-in powers exercised, in other relevant jurisdictions may be recognized, and given effect to, under HKSAR law by way of the Resolution Authority making a recognition instrument after consultation with

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[105] A multilateral system among participating financial institutions used for clearing, settling or recording payments, securities, derivatives or other financial transactions and includes any payment system, central securities depository, securities settlement system, central counterparty and trade repository: section 2(1) of the Resolution Ordinance.

[106] Defined in section 86 of the Resolution Ordinance as meaning, in relation to a qualifying contract:

(a) a right to terminate the contract;

(b) a right to accelerate, close out, set off or net obligations, or any similar right that suspends, modifies or extinguishes an obligation of a party to the contract; or

(c) a right to prevent an obligation from arising under the contract.

[107] A contract is a "qualifying contract" if the obligations provided in it for payment and delivery and for provision of collateral continue to be performed (section 88 of the Resolution Ordinance).

[108] Crisis prevention measure' refers to the exercise of certain powers/taking of certain actions by the resolution authority, including in relation to resolution planning, exercise of one of the stabilization options, mandatory reduction of capital instruments or certain actions in relation to non-HKSAR resolution actions.

the Financial Secretary.[109] Such a recognition instrument may be in respect of all or part of the non-HKSAR resolution action and may be in respect of entities that are not within scope financial institutions. A Resolution Authority must not make a recognition instrument if it is of the opinion that doing so would:

(i) have an adverse effect on financial stability in the HKSAR;

(ii) not deliver outcomes that are consistent with the resolution objectives; or

(iii) disadvantage HKSAR shareholders or creditors (or both) relative to other shareholders or creditors.

4.22.19 As soon as possible after making a recognition instrument, the Resolution Authority must send a copy to the non-HKSAR entity in question, publish a copy on its website, in the Gazette and two newspapers. The effect of recognition is that the non-HKSAR resolution action would have substantially the same legal effect in the HKSAR that it would have produced if it had been made under the laws of the HKSAR.

4.22.20 A Resolution Authority may exercise its powers under the Resolution Ordinance to support the taking of a non-HKSAR resolution action if it is of the opinion that doing so would be consistent with the resolution objectives.

5 Addressees of this Memorandum, purpose and reliance

This Memorandum of law is addressed to the FIA and ISDA solely for their benefit and the benefit of their members in relation to their use of a Clearing Agreement. No other person may rely on this Memorandum for any purpose without our prior written consent. This Memorandum may, however, be shown by the FIA, ISDA, an FIA member or an ISDA member to a competent regulatory or supervisory authority or professional advisors for such member, the FIA or ISDA for the purposes of information only, on the basis that we assume no responsibility to such authority or any other person as a result, or otherwise.

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[109] Part 13 of the Resolution Ordinance. A recognition instrument may only be made if, in the opinion of the Resolution Authority, (i) it would not have an adverse effect of financial stability in the HKSAR; recognition would not deliver outcomes that were inconsistent with resolution objectives; or (iii) would not disadvantage HKSAR creditors and/or shareholders relative to other creditors and/or shareholders.

Annex 1
Summary Annex

summarising the arrangements under the Clearing Agreement in respect of the Agent-Trust and Statutory Trust

March 23, 2025

*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 notes in the text below are to paragraphs and notes 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**") between an FCM and its customer, the FCM maintains one or more accounts on its books and records in the customer's name (individually or collectively, the "**customer account**"), and the customer authorizes the FCM, to execute, carry and clear contracts for the purchase and sale of US futures, foreign futures and/or cleared swaps[1] on behalf of the customer (with respect to the customer, its "**contracts,**" which are referred to in the S&C Memo as "t**ransactions**").[2] The effect of this authorization, and the FCM's acceptance, is to cause the FCM to become the customer's agent for these purposes.[3] If the customer clears only futures, the customer agreement will consist of a customer account agreement (a "**base account agreement**"). If the customer clears only cleared swaps or it clears both futures and cleared swaps, the customer agreement will consist of a base account agreement together with a cleared derivatives addendum ("**CDA**"). In either case, the customer agreement may also include 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 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.[4]

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[1] 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 ("**FCO**").

[2] As used herein, "**contract**" means, depending on the context, either (i) a term of reference describing a unit of trading in a particular futures or cleared swaps product or (ii) a futures or cleared swap product approved and designated for trading or clearing pursuant to the rules of an exchange or other trading venue or clearing organization.

[3] The customer agreement establishes (i) a debtor-creditor relationship between the FCM and the customer in respect of the customer 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.

[4] Some customer agreements also explicitly include the customs and practices of the clearing organizations and trading venues relevant to the customer's contracts. In addition, to the extent the customer agreement is governed by New York law, it would generally be interpreted

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 contracts. To the extent that the contracts 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 as well as the contracts and the cash, securities and other property (collectively, "**funds**") credited to the customer account, as discussed in paragraphs 1.37 through 1.42. 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 close its open contracts or instruct the FCM to transfer them 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 customer account. Rule 2-27 of the National Futures Association (the "**NFA**") also requires an FCM, upon receipt of an instruction from a customer to transfer its customer account (or portions thereof) to another FCM, to effect the transfer of balances and positions to the other FCM in accordance with the terms of Rule 2-27 (and such an instruction could be given by the customer without terminating the customer agreement). Additionally, CFTC Rule 39.15(d) mandates that a DCO must have rules providing that the DCO will promptly transfer all or a portion of a customer's positions, and related funds as necessary, from the clearing member of the DCO that carries the customer account to another clearing member, without requiring the close-out and rebooking of the contracts outstanding prior to the requested transfer, subject to certain conditions, including, among other things, that the customer has instructed the carrying clearing member to make the transfer and that the customer is not currently in default to the carrying clearing member.

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 customer 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 customer account and any other amounts that may be credited or debited to the customer 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 funds received by the FCM from, for or on behalf of customers to margin, guarantee or secure 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

in accordance with the customs and practices of the futures industry as a whole, as well as in accordance with other standard rules of contractual interpretation.

1.16, 1.18 and 1.20). To ensure that the FCM maintains books-and-records segregation consistent with these rules, if a customer clears contracts in multiple product classes, 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**" may refer, as the context requires, to any account class or all account classes on a combined basis maintained by the FCM for a customer under a customer agreement.

1.6 The customer agreement establishes the customer account as a mutual, open and running account between the customer and the FCM.[5] A mutual open account is an account in which, by agreement of the parties, a connected series of debit and credit entries of reciprocal[6] 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 funds are credited to a customer account (whether as margin deposited by, or as gains accruing to, the customer), and funds are debited from the customer account (whether as charges payable by the customer or withdrawals to return funds to the customer or deliver them to another party), the balance of the customer 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 customer account represent one single indivisible liability, represented by the customer 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.[7] Like other types of account agreements, the customer agreement generally provides no details as to the operation of the customer 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 1.31, to which the customer account is subject.[8] This balance – the customer 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 Customer Property Rules discussed in paragraphs 1.132 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 1.32 through 1.36.

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5 The terms "open" and "running" indicate that the business relationship reflected in the account is ongoing. *See* 1 C.J.S. Account, Action on § 1 ("More specifically, an open account involves ongoing charges by one party and payments by another party, where the parties have not settled the charges, or where there are running or current dealings between them and the account is kept open in expectation of future dealings.").

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

7 This intention applies both 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.

8 The customer 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.

1.7 Under CFTC rules, for purposes of determining the amount that the FCM must segregate or set aside,[9] 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,[10] (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, prior to default, the net liquidating equity reflected in a customer account is determined in accordance with customer margining standards (the "**margining standards**") established by the "Joint Audit Committee," a representative committee of SROs, including the NFA 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. The margining standards (which address, among other things, when the FCM must call for margin, how excess margin is calculated, when 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 note 9, 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 1.285 through 1.31 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 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 an FCO (as a direct member of the FCO). *See* the S&C Memo, Section VII.

1.9 When the FCM clears US futures or cleared swaps for the customer, the FCM clears the contracts directly with the DCO, which credits the contracts to an omnibus customer positions account[11] of the FCM at the DCO maintained in the name of the FCM for the benefit of its customers in the relevant account class.[12] The FCM, in turn, credits the contracts to the customer account of the relevant customer on the FCM's books. Similarly, in the case of the customer's foreign futures, the foreign futures broker clears the contracts with the relevant FCO, which

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[9] As discussed in note 28, 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.

[10] *See* the discussion of unrealized gains and losses in paragraph 1.30.

[11] 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.

[12] 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 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 FCM 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.

credits the contracts to an omnibus account with the FCO maintained in the name of the foreign futures broker for its customers, and the foreign futures broker, in turn, credits the contracts 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 contracts to the customer accounts of the relevant customer on the FCM's books. Accordingly, for every contract, there are at least two relevant accounts: (i) the customer account on the FCM's books in the name of the customer to which the FCM credits all contracts cleared for that customer by the FCM across all DCOs or FCOs, and (ii) an omnibus customer positions account of the FCM at the applicable DCO, or foreign futures broker, to which the FCM's customer contracts for all its customers in the relevant account class at that DCO, or foreign futures broker, are credited.

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). In neither case is the FCM's customer a party to the contracts. 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 under the contracts and the customer has no rights or claims against the DCO or foreign futures broker under the contracts. Moreover, from a US law perspective, the FCM is not in privity of contract with the FCO. The FCM is fully liable as principal for all amounts owing to the DCO or foreign futures 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 contracts cleared by the FCM on behalf of the customer. This reflects the fact that, as the sole counterparty and principal obligor to the DCO or foreign futures broker under the contracts cleared by the FCM on the customer's behalf with the DCO or foreign futures broker,[13] 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 — but the customer is the beneficial owner (*i.e.*, the owner in equity) of the contracts cleared by the FCM on the customer's behalf and credited to the omnibus customer positions account at the relevant DCO or foreign futures broker, 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[14] for the customer by the FCM.[15] Because contracts that have the same terms (*e.g.*, futures contracts for the same commodity and delivery month traded on the same exchange) are fungible and are held by the FCM for all its customers for which it clears and maintains open positions in such fungible contracts, the customer does

[13] The precise nature of what the FCM holds for the customer when it clears contracts through a foreign futures broker will depend on the structure of those contracts and the laws governing those contracts and the relationship with the foreign futures broker. If the FCM is a party to the contracts, it would be an agent-trustee for the customer in respect of the contracts.

[14] 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.

[15] 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 the 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.

not have an interest in or any claim to any specific contract, but rather maintains a *pro rata* beneficial interest in such fungible contracts as a whole.[16] *See* Section VI of the S&C Memo.

Customer funds

1.12 As noted above, an FCM is required to segregate customer funds. 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 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 on 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 to the segregated assets, 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 (as defined in paragraph 1.15) 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),[17] and other registered FCMs (each, a "**depository**"), in

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[16] There do not appear to be any cases that evaluate the precise scope of the customer's interest in the contracts carried by the FCM, if only because the nature of the customer's interest in the underlying contracts would not determine the outcome in the context of the FCM's insolvency pursuant to the CFTC's Part 190 rules." S*ee* paragraphs 1.32 – 1.36. Additionally, the nature and scope of the customer's interest in futures contracts cleared for it are entirely irrelevant in determining how the FCM may perfect its security interest in such contracts under the UCC. As discussed in note 452, the customer's futures contracts are, by definition, "commodity contracts" carried in a "commodity account" by the FCM as the customer's "commodity intermediary." As a result, under UCC Article 9, the FCM's security interest may be perfected by the FCM's control of the customer account, which the FCM has automatically by virtue of its status as a commodity intermediary, and there is no need to consider the nature and scope of the customer's interests in such contracts. In contrast, if the FCM and customer elect to treat the customer's cleared swaps as "financial assets" credited to a "securities account" maintained for the customer by the FCM as the customer's "securities intermediary" for purposes of UCC Article 8, the rights and interests of the customer in respect of its cleared swaps under the indirect holding provisions of Article 8 parallel the rights and interests of the customer against the FCM as agent-trustee described above. However, even in the case of cleared swaps that are subject to a financial asset election, the nature and scope of a customer's rights and interests in such cleared swaps do not determine their treatment under the CFTC's Part 190 rules in the FCM's insolvency. *See* the discussion in note 43.

In any event, the customer's interest should not extend beyond the contracts that are for the same commodity and delivery month and traded on the same exchange, if only because the FCM cannot be said to have executed any other contract on behalf of that customer.

[17] 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.

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 Customer Property 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 each 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 to the segregated funds 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 established by the CEA and related regulations; they are distinct from the common-law agent-trustee relationship described above, under which the FCM carries customer 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,"[18] the scope of the statutory trusts, and the duties of the FCM with respect to the customer funds, 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 generally would not be permitted in relation to a classic common-law trust. Several examples demonstrate these differences. 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 ("**permitted investments**") and retain as its own any resulting income – something that would not be permitted to a common-law trustee.[19] Second, as noted above, 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" (*i.e.*, 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 customer contracts – whether for the same or for a different customer – as discussed in paragraph 1.19. *See* the S&C Memo, Section VI.B.

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 by futures commission merchants before the enactment of the CEA. Some commission merchants in the futures markets used customer funds belonging to one customer to extend credit to more favored

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[18] 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 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).

[19] Examples of permitted investments include (i) investments (including by means of reverse repo transactions) of customer funds in the form of cash in various types of highly liquid securities and (ii) sales of customer funds in the form of securities by means of repo transactions. In all cases, the FCM must also segregate the permitted investments that it makes with segregated funds and must bear any losses arising from the investments. This segregation requirement serves to ensure that sufficient value is maintained in segregation or set aside so that it is available at all times to satisfy customer claims, including in the FCM's bankruptcy.

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 contracts.

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). The funds held in segregation may be the actual funds received from customers or for the customers' account, or may be other funds derived by the FCM from other sources.[20] In addition, to prevent the use of one customer's funds to margin or settle another customer's positions, the FCM must have, 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, a residual interest in its segregated funds account on the following business day in an amount at least equal to the sum of the undermargined amounts of customer accounts in the same account class. Furthermore, the FCM maintains additional funds in segregation (as part of its residual interest) in excess of its total obligations to all customers to protect against becoming undersegregated at any time.[21] If the FCM discovers at any time that it holds insufficient funds in its segregated funds account for an account class to satisfy the segregation requirement or the undermargined amounts requirement for the account class, it must immediately deposit sufficient funds into its segregated funds account to bring the account back into compliance. The FCM may make withdrawals from its segregated accounts 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, subject to certain limitations and conditions (including the 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 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 under the customer agreement but not necessary to the execution or maintenance of its contracts may not be paid directly from segregated funds (because 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 customer 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.B.

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[20] Although cash margin is fungible, such that it would be impossible to determine whether the cash held in segregation is or is not the same cash that the FCM received from, or for the account of, the customer, the same rule applies to non-fungible margin, such as margin in the form of securities. The FCM may hold the actual securities received from the customer in segregation, or may segregate cash with a value equal to that of the securities, in lieu of the securities themselves. *See* note 19.

[21] 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.

Foreign futures

1.20 The Customer Property Rules for foreign futures are parallel to, but are separate from, the Customer Property Rules for customer 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, FCOs 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 FCOs, 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)[22] 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 made in 2013, requirements regarding the margin provided by foreign futures customers were substantially less robust than the segregation requirements established by the Customer Property Rules for US futures and cleared swaps, and 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 treatment substantially equivalent to the treatment already provided

[22] As used herein, "**separate account funds**" means the funds credited to a separate account, including in respect of the FCM's residual interest.

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 that are substantially similar across the three account classes. Like the futures and cleared swaps 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 specific 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.D.

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 FCM'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 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 swap cleared by a DCO, the FCM will be required to satisfy the DCO's initial margin requirement for the position by delivering funds to the DCO to be held in the DCO's account with its depositary.[23] The DCO will credit the funds received from the FCM to the omnibus customer margin accounts for customers of the relevant account class on the books of the DCO. 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 of any customer 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.[24] Furthermore, the amount of initial margin required with respect to a contract may change over the term of the contract; if that occurs, the FCM will be required to deliver additional funds to the DCO, or will be entitled to receive the return of the now-excess funds from the DCO, on the same basis.

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[23] *See* note 17.

[24] A DCO will calculate initial margin in respect of an FCM's 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.

1.26 In addition, for each open position of the customer in a contract in respect of which the DCO and FCM exchange variation margin amounts,[25] 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,[26] (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 any action by the FCM. Any other DCO clearing open positions of the same customer in the same account class will conduct a similar variation margin settlement process. Because all these debits and credits are made by each DCO to the FCM's segregated funds account,[27] 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.

1.27 If, at any time at or following the establishment of an open position, the FCM holds insufficient funds of the customer to fully cover the DCO's initial or variation margin requirements, the FCM will be required to use its own funds, whether or not it is then able to obtain additional margin in the requisite amount from the customer.

Example of margining between the FCM and customer in respect of US futures and cleared swaps

1.28 If the customer's net liquidating equity is less than the applicable margin requirement for its customer account, the customer 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

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[25] 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.

[26] 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 as between the DCO and the FCM, rather than transfers of collateral that secure such exposures. As a result, if the FCM pays variation margin to the DCO, the DCO is not obligated to hold the variation margin for the benefit of that FCM in the omnibus customer margin account maintained on its books. However, daily settlement by the FCM and DCO of the variation margin amounts in respect of open positions does not result in the positions being considered settled or closed.

[27] 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 in which all customers within that account class have an interest. 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.

requirement.[28] 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 (or credited to one of the FCM's segregated securities custody accounts, in the case of non-cash funds), 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, which may include the FCM's omnibus customer margin accounts for customers of the relevant account class on the books of one or more DCOs (which may or may not be DCOs through which the FMC has cleared positions for that customer).[29] Each of the cash and non-cash balances in the customer account on the FCM's books represents funds deposited by the customer with the FCM or derived from the customer's contracts, and those balances are not adjusted when the FCM deposits initial margin with a DCO in respect of the customer's contracts as a result of establishing positions in the customer's contracts cleared through the DCO, or when the DCO releases initial margin to the FCM as a result of closing those positions.

1.29 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 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.

1.30 From the time 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[30] until the position is closed, daily trading gains or losses will increase or decrease the position's open trade equity reflected in the customer 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 (notwithstanding the cash payments made between the FCM and the DCO, as described in paragraph 1.25), but will increase or decrease open trade equity (and the customer account's net liquidating equity); increases in open trade equity resulting from unrealized gains in a customer's account represent "settled cash" that can support new trading by that customer.[31] When the position is

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[28] As noted above, a different definition of "net liquidating equity" is used for determining the customer's margining requirement (as opposed to determining the FCM's segregation requirement and the other purposes described above). 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 customer 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 cleared swaps and US futures, other than options on futures with "equity-style" margining (see note 25)), (ii) the customer account's cash balance, (iii) the collateral value of non-cash margin and (iv) if the FCM 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, as discussed in paragraph 1.30). 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 customer account by the customer and (C) commissions, brokerage fees, taxes, interest and other charges to the account.

[29] *See* paragraph 1.36.

[30] See note 25.

[31] As discussed in paragraph 1.26, the daily settlements of variation margin amounts between the DCO and the FCM acting on behalf of its customers in respect of open positions constitute final settlement of the gains and losses as between the DCO and the FCM. However, because the FCM does not credit the customer account with corresponding cash credits or debits, they 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

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

1.31 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.[32]

Treatment of customer property in the FCM's bankruptcy

1.32 In the event of an FCM's bankruptcy, the "**customer property**" of the FCM 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 (the "**Code**"), 11 U.S.C. §§ 761-767 ("**Subchapter IV**"), and the CFTC's Part 190 bankruptcy rules, 17 C.F.R. §§ 190.00 *et seq.* ("**Part 190**").[33] Section 761 of Subchapter IV defines "customer property" to mean "cash, a security, or other property, or proceeds of such cash, security, or property, received, acquired, or held by or for the account of the [FCM], from or for the account of a customer," including, among other things, (i) an open commodity contract; (ii) property received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract; (iii) profits or contractual or other rights accruing to a customer as a result of a commodity contract; (iii) specifically identifiable property (as defined below); (iv) a security held as property of the FCM to the extent such security is necessary to meet a net equity claim based on a security of the same class and series of an issuer; (v) property that was unlawfully converted from and that is the lawful property of the estate; and (vi) "other property of the [FCM] that any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer, unless including such property as customer property would not significantly increase customer property . . . ." Additionally, the CFTC is given very broad statutory authority in Section 20 of the CEA to specify "by rule or regulation . . . that certain cash, securities, other property or commodity contracts are to be included in or excluded from customer property." The CFTC has exercised this authority to further specify in Part 190 that customer property includes, among other things, property that: (1) is segregated for customers on the "**filing**

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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. However, because the unrealized gains represent "settled cash" of the customer, the payments of variation margin between the FCM and the DCO result in increases or decreases in the customer's net liquidating equity claim against the FCM, increasing or decreasing the FCM's segregated funds requirement for the applicable account class and the customer's claim against those segregated funds.

[32] 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.

[33] Enacted by Congress as part of the Bankruptcy Reform Act of 1978, Subchapter IV lays out a high-level framework for bankruptcy liquidations of FCMs (and DCOs) that was based largely on recommendations of the CFTC to address concerns it had with respect to the treatment of customer property in an FCM's bankruptcy. *See Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary*, 94th Cong., 2d Sess. 2377-2420 (1977) (testimony of William T. Bagley, former CFTC Chairman) [hereinafter "***Bagley***"]. Subchapter IV's high-level framework is supplemented by the Part 190 rules, which were promulgated by the CFTC in 1982 to provide more detailed procedures to guide bankruptcy trustees and assist courts in conducting Subchapter IV proceedings in a manner consistent with the Customer Property Rules. *See* A. Corcoran and S. Erwin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms*, 44 Wash. & Lee L. Rev. 849, 871 (Summer, 1987) [hereinafter "***Corcoran-Erwin***"].

date" (which is the date on which (x) a petition under the Code, or an application under the Securities Investor Protection Act ("**SIPA**"), is filed commencing a proceeding with respect to an FCM, or the Federal Deposit Insurance Corporation ("**FDIC**") is appointed as receiver of the FCM under the Orderly Liquidation Authority); (2) was "received, acquired, or held to margin, guarantee, secure, purchase or sell a commodity contract" that is subsequently recovered by the avoidance powers of the trustee; (3) constitutes current assets of the FCM, including its trading or operating accounts and commodities held in inventory, in the greater of (a) the amount that the FCM is obligated to set aside as its targeted residual interest with respect to each account class and (b) the FCM's obligations to cover debit balances or undermargined amounts as provided in the Customer Property Rules; and (4) is property of the FCM's estate, including its trading or operating accounts and commodities held in inventory, to the extent that the other listed categories of customer property are insufficient to satisfy in full all claims of its "**public customers**," which are all its customers other than its "**non-public customers**," which are its affiliates and insiders who clear through the FCM in its proprietary accounts.

Priority of customer claims to, and the pro rata distribution of, customer property

1.33 Subchapter IV provides for the administration of customer property in an FCM's bankruptcy as property of the FCM's estate and treats the FCM's customers as creditors of the estate, but it also requires the FCM's bankruptcy trustee to distribute the FCM's customer property ratably to the FCM's customers on the basis and to the extent of such customers' allowed net equity claims, and in priority to claims of all other creditors of the FCM, except for certain administrative expenses related to customer property (the "**statutory preference**").[34] Part 190 further specifies the manner in which 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

[34] The statutory preference, Subchapter IV's definition of customer property and the CFTC's statutory authority to determine by rule or regulation which property will be included in or excluded from customer property largely track CFTC recommendations intended to address concerns that it had as to whether an FCM's bankruptcy trustee would trace or identify, and grant the FCM's customers a preference to, funds deposited by them to secure or margin their contracts. Prior to Subchapter IV's enactment, the segregation requirements of the Customer Property Rules had no counterpart in US bankruptcy laws and, as a result, the special treatment of customer funds in an FCM's bankruptcy was "open to speculation." *Bagley* at 2378. In the absence of an express statutory preference, the CFTC had argued that a bankrupt FCM should be treated as a trustee of its customer funds and that to the extent such funds could be traced and identified, they could be reclaimed by the FCM's customers. Although bankruptcy trustees did award preferences to customers with respect to customer funds actually held by FCMs in segregation at the time of bankruptcy, the theory under which they did so was unclear, with the preferences based on differing *ad hoc* adaptations of traditional trust law to FCMs or the application of pre-1938 law governing securities broker-dealer bankruptcies (for a description of the treatment of customers of bankrupt broker-dealers prior to 1938, *see* K. Kettering, *Repledge Deconstructed*, 61 U. Pitt. L. Rev. 45, 70 (Fall, 1999) [hereinafter, "***Kettering***"]. Moreover, there was no clear statement of the law. The cases in the area had resulted in vague decisions that did not clearly explain why preferences had been awarded or disallowed and those decisions had not been tested at an appellate level. In the case of customer funds not in actual segregation at the time of the bankruptcy (because, for example, they had been wrongfully diverted from segregation), customer claims to such funds were generally rejected outright, even when such funds were easily traceable, leaving customers without a priority claim and relegated to the status of general creditors. The CFTC also worried more generally that the commingling (permissible under the Customer Property Rules) of customer funds and an FCM's own funds (in the form of its residual interest) could make it much more difficult for a trustee to trace and identify customer funds and that such commingling, together with the FCM's right to invest customer funds and retain the profits therefrom, could result in a trustee finding that the FCM did not hold customer funds in trust for its customers and that they should not be given a preference to customer funds with which the FCM's own funds had been commingled.

Addressing these concerns, the customer property definition "provides a basis for assuring that commodity customers receive priority claims that are coextensive with their ownership interests in funds and property held by the bankrupt FCM as defined by Section 4d(2) of the CEA." Corcoran-Erwin, *supra* note 33, at 874. The definition establishes that "an FCM's improper commingling of commodity customer funds, whether with its own trading accounts or other funds, does not deprive customers of priority claims to such funds wherever they can be found . . . [and] provides a basis for reaching other assets of the FCM to restore customer funds missing from an estate through diversion or other abuse." *Id.* at 875. Moreover, Subchapter IV provides that customer property includes assets of the FCM to the extent that available segregated funds are insufficient to satisfy public customer claims without regard to whether such assets were diverted from segregation, and this result is confirmed by Part 190's specification that customer property includes property of the FCM's estate, including its trading or operating accounts and commodities inventory, to the extent that other enumerated categories of customer property are insufficient to fully satisfy public customer claims. *Id.* As Corcoran and Erwin explain, the customer property framework assures "that difficulties in tracing customer funds will not unfairly disadvantage customers to the benefit of the [debtor FCM's] general creditors, establishing by rule a variation on the presumption drawn from English trust law that 'where a wrongdoer commingles his own funds in a bank account with those of another person and thereafter makes withdrawals from that account, the wrongdoer withdrew his own funds first.'" *Id.*

FCM's public customer class and its non-public customer class (each, a "**customer class**"). 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 be distributed only to customers in that account class (including by means of a transfer of property to a third party on a customer's behalf, return of property to a customer or distribution to a customer of valuable property that is different than the property posted by the customer), and if the customer property for an account class is insufficient to satisfy all the net equity claims of public customers in the account class, such customer property is distributed *pro rata* to the public customers in respect of those claims. Any customer property not attributable to a specific account class, or that exceeds the amount needed to pay allowed customer net equity claims in a particular account class, is distributed to public customers in other account classes so long as there is a shortfall in those other account classes. Non-public customers do not receive any distribution of customer property so long as there is any shortfall, in any account class, of customer property needed to satisfy public customer net equity claims. The *pro rata* distribution principle means that, if there is a shortfall of customer property in an account class, all customers in the account class suffer the same proportional loss relative to their allowed net equity claims. The principle applies to all customers, including those who post as collateral specifically identifiable property.[35]

Bulk transfers of customer contracts and funds that are not specifically identifiable property

1.34 Subchapter IV and Part 190 also contemplate prompt efforts by an FCM's bankruptcy trustee to effect transfers of all or a portion of the FCM's customer property to other FCMs. Although Subchapter IV does not expressly mandate the trustee attempt to effect transfers of customer positions (except, as described below, in the case of contracts that the trustee designates as specifically identifiable property, so long as the value of the contracts does not exceed the customer's *pro rata* share of customer property), Part 190 articulates a policy preference for porting open contracts of the debtor FCM's public customers, along with all or a portion of the customers' account equity. Part 190 requires the trustee to promptly use its best efforts to effect a bulk transfer to one or more transferee FCMs of all eligible customer accounts and customer property held by the debtor FCM for or on behalf of its customers, based on customer claims of record, no later than the seventh calendar day after the "**order for relief**," which is (i) the commencement of a voluntary case under the Code (*i.e.*, the filing of a petition), (ii) the entry of an order for relief in an involuntary case under the Code, (iii) the issuance of a protective decree with respect to the FCM under SIPA or (iv) the appointment of the FDIC as receiver of the FCM under the Orderly Liquidation Authority. To facilitate such transfers, Part 190 authorizes the trustee to conduct the FCM's business on a limited basis, with specific provisions authorizing the trustee's collection of margin from customers and payment of margin to DCOs, foreign futures brokers and other clearing intermediaries for open positions to better assure they remain open prior to transfer. As a general matter, all customer accounts (including accounts with no open contract positions) are eligible for transfer after the order for relief, other than the FCM's own account and customer accounts that are in deficit (*i.e.*, accounts with negative balances). However, Part 190 prohibits any transfer by the trustee if, after taking into account all customer property available for distribution to customers in the applicable account class at the time of transfer, the transfer would result in insufficient remaining customer property to make an equivalent percentage distribution (including all previous transfers and distributions) to all customers in the same account class. Customers whose customer accounts, contracts and funds are included in a bulk transfer have no consent rights with respect to the transferee FCM.[36] Part 190 requires the trustee to liquidate "as soon as practicable under the circumstances" all open contracts in any customer account that is in deficit, or for which any mark-to-market calculation would result in a deficit, or for which a customer fails to meet a margin call made by the trustee within a reasonable time. The trustee must also promptly liquidate any open contracts that have not been transferred by

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[35] As Corcoran and Erwin explain, the *pro rata* distribution requirement "establishes a principle of equal treatment for all customers and effects a proportionate allocation of any shortfall in customer property available for distribution, a standard that accords with established law under the CEA, common law trust precepts, and the bankruptcy principle that 'equality is equity.'" Corcoran-Erwin, *supra* note 33, at 876-877.

[36] Any customer that objects to the selection of the transferee FCM can elect to move its account to another FCM of its own choosing following the bulk transfer away from the bankrupt FCM, as described in paragraph 1.3.

the seventh day following the order for relief (other than open contracts that are specifically identifiable property and are subject to customer instructions to transfer rather than liquidate, as discussed below).

Specifically identifiable property

Return or transfer of specifically identifiable property other than customer contracts

1.34.1 The provisions of Subchapter IV and Part 190 relating to the disposition of a customer's "**specifically identifiable property**" (as described below) establish a method for transferring such property (even if a bulk transfer of the FCM's customer accounts cannot be achieved) that give a customer some control over the disposition of the property, subject to satisfaction of conditions that are intended to ensure that the disposition does not undermine the equity of the ratable distribution of customer property. Subchapter IV refers to, but does not define, "specifically identifiable property." Rather, the CFTC is granted broad authority by CEA Section 20 to provide, by rule or regulation, that "certain cash, securities, other property, or commodity contracts are to be specifically identifiable to a particular customer in a specific capacity . . ." The CFTC has exercised this authority to define specifically identifiable property quite narrowly in Part 190 to mean the following property: (A) any security that as of the filing date is (1) is held for the account of a customer, registered in such customer's name and not transferable by delivery and has a duration or maturity date of more than 180 days or (2) is fully paid, non-exempt and identified on the FCM's books and records as held for or on behalf of the account of a customer for which no open contracts were held in the same capacity; (B) any warehouse receipt, bill of lading or other document of title that as of the filing date can be identified on the FCM's books and records as held for the account of a particular customer and is not in bearer form and is not otherwise transferable by delivery; (C) certain physical delivery property; and (D) certain open contracts in hedging accounts that the trustee elects to treat as specifically identifiable property (as described below in paragraph 1.34.2). If an order for relief has been entered, Section 190.03(c)(1) of Part 190 requires the trustee to use all reasonable efforts to promptly notify any customer whose account includes specifically identifiable property, other than open contracts, which has not been liquidated, that such property may be liquidated on and after the seventh day after the order for relief (or such other date as is specified by the trustee with the approval of the CFTC or the applicable court) if the customer has not instructed the trustee before the deadline specified in the notification to the customer to return the property. If the customer instructs the trustee to return specifically identifiable property, the customer generally must provide "substitute customer property" (consisting of cash or cash equivalents) with a value equal to the property returned. The purpose of this requirement, under which customers must effectively "buy back" their specifically identifiable property by depositing substitute customer property, is to preserve the *pro rata* distribution principle. If the specifically identifiable property consists of securities, but the customer has no open contracts, the customer may request that the trustee purchase or otherwise obtain the largest whole number of like-kind securities (*i.e.*, securities of the same class and series of an issuer), with a fair market value (inclusive of transaction costs) that does not exceed that portion of the funded balance of such customer's allowed net equity claim that constitutes a claim for securities, if like-kind securities can be purchased in a fair and orderly manner.

Transfer of customer contracts that the trustee elects to treat as specifically identifiable property

1.34.2 The trustee has the right, but not an obligation, to treat as specifically identifiable property open contracts of public customers held in hedging accounts designated as such in the FCM's records, after consulting with the CFTC and when practical under the circumstances. In the case of open contracts that the trustee elects to treat as a public customer's specifically identifiable property, Section 190.03(a)(2) of Part 190 provides that the trustee must use reasonable efforts to promptly notify the customer of its determination. If the FCM's books and records reveal a clear preference of the customer with respect to the contracts' transfer or liquidation, the trustee must endeavor, to the extent reasonably practicable, to comply with the preference. If the customer's preference cannot be clearly discerned from the FCM's books and records, the trustee must request instructions from the customer with respect to transfer or liquidation, specify a deadline for providing the instructions and further inform the customer that (i) if it does not provide the instructions by the deadline, the customer's open contracts will not

be treated as specifically identifiable property, (ii) any transfer of the contracts is subject to certain terms for distribution (described below), (iii) absent compliance with any terms imposed by the trustee or the court, the trustee may liquidate the contracts and (iv) providing instructions may not prevent the contracts from being liquidated. If the customer fails to provide the instructions to the trustee by the specified deadline, the contracts will not be treated as specifically identifiable property and they will be subject to bulk transfer or, failing that, to liquidation, as described above in paragraph 1.33. Section 190.09(d)(2) of Part 190 provides that any specifically identifiable contracts that are not required to be liquidated, and are not otherwise liquidated, may be transferred on the customer's behalf, but the customer must first deposit an equivalent value of substitute customer property to ensure full implementation of the *pro rata* distribution principle.[37]

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[37] Subchapter IV's provisions requiring *pro rata* distribution of customer property and facilitating transfers of customer contracts and funds to other FCMs reflect CFTC recommendations to address concerns that it had, prior to the enactment of Subchapter IV, with inequities in the distribution of funds to customers in cases involving inadequate segregation and the ability of customers to port open contracts and supporting margin and thereby maintain hedges (which was of particular importance to smaller customers, such as farmers or other producers of physical commodities, using futures to hedge their positions in the cash markets because they needed to keep their futures positions open as long as their cash positions were open). The CFTC believed that under then current law, only two alternative approaches were available for use by an FCM's bankruptcy trustee to distribute customer contracts and funds.

Strict tracing. Under the first approach, typically employed by trustees prior to the enactment of Subchapter IV, a trustee would, to the greatest extent possible, trace and return all specifically identifiable assets to customers to whom the assets were identified and then make a *pro rata* distribution to all customers of whatever residual remained after the initial distribution. The CFTC viewed this approach as preserving the hedging mechanism because specifically identified contracts and specifically identified funds margining those contracts could be readily transferred to another FCM (so long as the contracts were adequately margined). However, this strict tracing approach frequently resulted in serious inequities in the recovery of margin by (often larger, more sophisticated) customers who deposited margin in the form of securities (which were not considered fungible by the CFTC and were treated as specifically identifiable property returnable directly to such customers) versus (generally smaller, less sophisticated) customers who deposited margin in the form of cash (whose fungible nature often precluded tracing). If an FCM was inadequately segregated at the time of bankruptcy or otherwise not in a position that allowed tracing of all the cash deposited by customers, smaller cash-margin customers might recover only a small percentage of their investments upon the residual *pro rata* distribution while large customers who had posted securities margin could recover their entire investments through the return of specifically identifiable securities. This outcome was exacerbated by the Customer Property Rules in effect at the time, under which FCMs could accept securities as margin from customers 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 posted by customers as margin remained at the FCM and were readily traceable and returned to those 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. The CFTC stated that "the possibility that [an FCM's bankruptcy trustee] may use a strict tracing approach to distribute commodity customers' funds prevents any interpretation [or amendment] of [the Customer Property Rules] to permit a [DCO] to use the net equity in the securities deposited on behalf of one customer to margin or secure the trades of another." *Bagley* at 2395.

Strict pro rata distribution. Under the second approach, the trustee would liquidate and distribute to customers all applicable customer property in a single, strictly *pro rata* distribution. Such strict *pro rata* distribution eliminated the inequities that resulted from strict tracing, but it required the liquidation of all customer property, including the closing out of open contracts. In doing so, it destroyed the hedging mechanism for many customers since it left them with unhedged cash positions and prevented them from re-establishing hedge positions in the futures market until distribution of the FCM's estate.

CFTC recommendations. To address the shortcomings of these approaches, the CFTC recommended a third approach, as a combination of the other two approaches, which the CFTC doubted could be utilized under then current law but believed could both preserve the hedging mechanism and result in an equitable distribution of assets in the event of inadequate segregation. Subchapter IV, as enacted, reflects the CFTC's recommendations, which included, among other things, (i) *pro rata* distribution of customer property based on allowed net equity claims, (ii) a broad grant of authority to the CFTC to define by rule or regulation the customer property specifically identifiable to individual customers, (iii) tracing and return of specifically identifiable property to individual customers to the extent of each customer's *pro rata* share or, in the case of open contracts and corresponding margin, transfer to another FCM to the extent of each customer's *pro rata* share or liquidation upon the instruction or inaction of such customer, (iv) to the extent the value of specifically identifiable property, including open contracts, exceeded the value of a customer's *pro rata* share, opportunity for the customer to deposit sufficient cash to account for the differences and thereby gain the return or transfer of all such specific property. As the CFTC explained to Congress, "This [recommended approach] require[d] the return of specifically identifiable assets to the appropriate customers of the bankrupt without destroying the equity of a *pro rata* distribution, thereby protecting the unique ownership interests of commodity customers in specifically identifiable assets." *Bagley* at 2408.

1.34.3 The CFTC has recently signaled that the treatment of hedging contracts as specifically identifiable property is less likely in future FCM bankruptcies. In 2021, the CFTC amended Part 190 to provide, among other things, that an FCM's trustee has the option, and not an obligation, to designate customer contracts in a hedging account as specifically identifiable property and that to the extent that it elects not to do so, it must treat such contracts the same as other customer property subject to a bulk transfer. In its final adopting release for the amendment, the CFTC explained that giving the trustee this optionality reflected the policy preference to port all positions of all public customers. "Requiring a trustee to identify hedging accounts and provide hedging account holders the opportunity to keep their positions open may be a resource and time intensive process, which the [CFTC] believes could interfere with the trustee's ability to take prudent and timely action to manage the debtor FCM's estate to protect all of the FCM's customers."[38]

Implications of Subchapter IV and Part 190

Administration within the FCM's estate

1.35 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.[39] Indeed, Subchapter IV should be considered as providing a clear basis under US federal law for ensuring the efficacy of the Customer Property Rules in an FCM's bankruptcy. Administering customer property as provided in Subchapter IV and Part 190 facilitates a trustee's pursuit of avoidance actions to recover property for distribution to customers and provides 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.[40] Additionally, the *pro rata* distribution requirement and the customer property transfer provisions assure equality of treatment of all customers and promote customer portability in a manner that could not be achieved through application of the Customer Property Rules alone.

Customer margining

1.36 Because they eliminated the risk that a customer might receive a disproportionate share of the customer funds held by the FCM in its bankruptcy simply because that customer had provided margin in the form of securities, Subchapter IV and Part 190 also allowed the CFTC to modify the Customer Property Rules so that FCMs could repledge customer securities to DCOs to secure the FCM's obligations in respect of customer contracts it clears through the DCO. Today, the FCM has significant flexibility to use an individual customer's securities margin. For example, securities deposited with the FCM as margin by a customer may be deposited by that FCM with a DCO that does not clear the customer's contracts (so long as the contracts at the DCO secured by the customer's securities are in the same account class as the customer's contracts on other DCOs), and the FCM may rehypothecate customer securities margin for cash under repo agreements (but the FCM must maintain such cash in segregation and bears sole responsibility for any losses in respect of the repos).

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[38] 86 Fed. Reg. 19324, 19343 (April 13, 2021).

[39] A similar treatment occurs under 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. *See also* note 423.

[40] The Code turns to applicable state or other non-insolvency law, in the first instance, to determine whether property is property of the bankruptcy estate. To the extent that property held by the FCM for customers were viewed as property of the customers under the CEA and applicable state law, it would not be recoverable by the bankruptcy trustee in an ordinary bankruptcy.

Customer Collateral

1.37 Under the terms of the customer agreement,[41] the customer typically grants to the FCM a first priority security interest in, lien on and right of set-off against, all the rights and interests of the customer in respect of 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, FCO, 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, FCO, 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, FCO, foreign futures broker or other person acting for or on behalf of any of the foregoing), in respect of the customer account or the customer's contracts; and

(iv) all proceeds of the foregoing.

1.38 This 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. Furthermore, like any security interest, 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 account.

The customer account and customer contracts

1.39 Under the New York Uniform Commercial Code (the "**UCC**"), a customer's US futures account and foreign futures account are categorized as a "commodity account" maintained for the customer, which is "commodity 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" (as each such term is defined in Article 9 of the UCC).[42] If the FCM and customer elect to treat the customer's cleared swaps as "financial assets," and the customer account constitutes a "securities account" maintained for the customer by the FCM as the customer's "securities intermediary," then the indirect holding provisions in Part 5 of UCC Article 8 apply, and when the FCM credits cleared swaps to the customer account, the customer obtains, and is treated as an "entitlement holder" of, "security entitlements" to such cleared swaps (as each of those terms is defined in the indirect holding provisions of Article 8 of the UCC).[43] Commodity contracts and security entitlements are types of "investment property" and are not

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[41] Even prior to the adoption of the relevant provisions of the UCC, an FCM generally was viewed as having a common-law "broker's lien" on its customers' accounts and any property credited to those accounts.

[42] A "**commodity account**" is defined in UCC Section 9-102(a)(15) as "an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer." A "**commodity contract**" is defined in UCC Section 9-102(a)(15) as a "commodity futures contract, an option on a commodity futures contract, a commodity option, or another contract if the contract or option is (A) traded on or subject to the rules of a board of trade that has been designated as a contract market for such a contract pursuant to federal commodities laws; or (B) traded on a foreign commodity board of trade, exchange, or market, and is carried on the books of a commodity intermediary for a commodity customer." A "**commodity intermediary**" is defined in UCC Section 9-102(a)(17) to include a person that "is registered as a futures commission merchant under federal commodities laws," and "**commodity customer**" is defined as a "person for which a commodity intermediary carries a commodity contract on its books."

[43] ***UCC Article 8***. The indirect holding provisions of Article 8 of the UCC set out rules that govern how interests in securities and other financial assets that persons indirectly hold through intermediaries are evidenced and transferred. Holding financial assets indirectly means that ownership of the financial assets is evidenced by book entries in accounts maintained by securities intermediaries for their customers.

See R. Hakes, *UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day*, 35 Loy. L.A. L. Rev. 661, 664 n.2 (2002) [hereinafter ***Hakes***].

Financial asset. A "**financial asset**" is defined in UCC Section 8-102(9) to include a security, as well as "any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under . . . Article 8" and so long as the UCC does not prohibit the treatment of the type of property in this manner. In this regard, UCC Section 8-103(f) provides that a "commodity contract" as defined in UCC Section 9-102(a)(15) is not a "security" or a "financial asset" as defined in UCC Article 8. Accordingly, because futures are commodity contracts, they may not be treated as financial assets. Cleared swaps, however, do not meet the definition of "commodity contract" (because they are not traded on boards of trade or exchanges) and they are not otherwise precluded from treatment as financial assets, and FCMs and their customers typically agree in Customer Agreements that the customers' cleared swaps will be treated as financial assets.

Securities account maintained by securities intermediary. In order for any financial asset to be subject to the indirect holding provisions in Part 5 of Article 8, the financial asset must be held in a securities account maintained by the FCM as a securities intermediary of the customer, and this is the case regardless of whether the financial asset is a security or is some other type of property, such as a customer's cleared swaps, that the parties affirmatively elect to treat as a financial asset. A "**securities account**" is defined in UCC Section 8-501(a) as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights comprising the financial asset." UCC Section 8-102(14) defines a "**securities intermediary**" to include "a person, such as a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity."

Customer account – a hybrid account. A customer's futures, cleared swaps and securities and cash margin will all be credited to the customer account, which is viewed by the parties as a "commodity account." This raises the question, given that futures are commodity contracts credited to a commodity account and cannot be financial assets credited to a securities account, of whether the customer account can be both a commodity account and a securities account. In this regard, the S&C Memo concludes that "[t]here is no reason under the UCC that a single account cannot be a 'hybrid' account addressed by both the commodity account and securities account provisions of Article 9 of the UCC." *See* S&C Memo at 80-81.

Security entitlement. When a financial asset (whether a security or any other financial asset, such as a cleared swap, that the parties have elected to treat as a financial asset) is credited to the customer account, and the customer account constitutes a securities account maintained for the customer by the FCM as its securities intermediary, the customer acquires, and becomes an "entitlement holder" of, a "security entitlement" to the financial asset. UCC Section 8-102(17) defines a "**security entitlement**" as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5 [of Article 8, which contains Article 8's provisions on security entitlements]." An "**entitlement holder**" is defined in UCC Section 8-102(7) as "the person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary."

Nature of security entitlement. Official Comment 1 to UCC Section 8-503 makes it clear that "[a] security entitlement is not a claim to a specific thing; it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary." The rights that are part of a security entitlement are the entitlement holder's rights under UCC Sections 8-505 through 8-508, which are the provisions that set out the duties of an intermediary to see to it that an entitlement holder receives all of the economic and corporate rights that comprise the financial asset. These duties include, among other things, duties to obtain and pass through to the entitlement holder payments and distributions in respect of the financial asset, to exercise ownership rights with respect to the financial asset on behalf of the entitlement holder if directed to do so by it, to obtain and maintain the financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset and to comply with entitlement orders and directions of the entitlement holder.

Pro rata property interest. A customer's property interest with respect to a particular financial asset is a *pro rata* property interest in all interests in that financial asset held by the FCM as a securities intermediary for all its customers that have security entitlements to that financial asset. UCC Section 8-503(a) states, "To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders . . . ." UCC Section 8-503(b) adds that "[a]n entitlement holder's property interest with respect to a particular financial asset . . . is a *pro rata* property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset." Official Comment 1 explains that "[UCC Section 8-503(b)] makes clear that the property interest described in [UCC Section 8-503(a)] is an interest held in common by all entitlement holders who have entitlements to a particular security or other financial asset . . . [and] all entitlement holders have a *pro rata* interest in whatever positions in that financial asset the intermediary holds."

Issue-by-issue basis. Official Comment 1 to UCC 8-503 further specifies that "[a]n entitlement holder's property interests under this [Section 8-503] is an interest with respect to a specific ***issue*** of securities or financial assets." [Emphasis added.] "For example," Official Comment 1 states, "customers of a firm who have positions in XYZ common stock have security entitlements with respect to the XYZ common stock held by the intermediary, while other customers who have positions in ABC common stock have security entitlements with respect to the ABC common stock held by the intermediary." Hakes explains:

> Subsection 8-503(b) describes the entitlement holder's property interest in a financial asset as a '*pro rata* property interest' in all interests in that financial asset held by the securities intermediary. Although it is not explicitly stated, the *pro rata* interest is implicitly limited

"general intangibles" as those terms are defined in UCC Article 9.[44] 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

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to the amount of the financial asset credited to the securities account. In other words, if the security entitlement is to 100 shares of IBM stock and the securities intermediary holds 100,000 shares of IBM stock, the security entitlement is a 1/1000 interest in each share of IBM stock held by the intermediary. It is important to note that this *pro rata* interest extends to financial assets acquired by the securities intermediary before the entitlement holder acquired the security entitlement as well as to those acquired thereafter. Thus, the fungible bulk in which an entitlement holder has a *pro rata* interest regularly changes. This *pro rata* interest in the fungible bulk of a particular financial asset, however, is not a claim to a specific asset held by the financial intermediary.

Hakes, *supra*, at 688. Both the examples provided by Official Comment 1 to UCC Section 8-503 and by Hakes suggest a customer holds a property interest only in cleared swaps that the FCM clears on behalf of the customer. Neither example suggests that the customer has a property interest in *all* cleared swaps of *all* customers of the FCM, including cleared swaps that are not cleared on behalf of the customer. The conclusion that a customer has property interests only in cleared swaps cleared on its behalf comports with Kettering's observation that "[the indirect holding provisions of UCC Article 8] provide that each customer . . . of a securities intermediary has a proportionate property interest in financial assets held by the intermediary for the customer's account (determined on an issue-by-issue basis, rather than by throwing all securities into a single pot as per the model of former [and current statutes governing the liquidation of bankrupt securities brokers])." Kettering, *supra* note 34, at 107.

Enforcement of entitlement holder's property interest. Official Comment 2 to UCC Section 8-503 states, "Although [UCC Section 8-503] recognizes that the entitlement holders of a securities intermediary have a property interest in the financial assets held by the intermediary, the incidents of this property interest are established by the rules of Article 8, not by common law property concepts." Article 8 provides that the property interest included in a security entitlement may be enforced against the intermediary only by the entitlement holder's exercise of its rights against the securities intermediary arising from its duties under UCC Sections 8-505 through 8-508. Additionally, the entitlement holder can look only to its intermediary for the performance of these duties. Official Comment 2 to Section 8-503 states, "The entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom the intermediary holds the positions, or third parties to whom the intermediary may have wrongfully transferred interests, except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing [and the intermediary is in insolvency proceedings]." Creditors of a debtor entitlement holder are similarly precluded from "looking through" the holder's securities intermediary (UCC Section 8-112(c) states, "The interest of a debtor in a security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained . . . .").

Insolvency of securities intermediary. Official Comment 1 to Section 8-503 makes it clear that if a securities intermediary is insolvent, applicable insolvency law, and *not* Article 8, will determine how its assets are to be distributed. Official Comment 1 states:

> Although [UCC Section 8-503] describes the property interest of entitlement holders in the assets held by the intermediary, it does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings. If the intermediary fails and its affairs are being administered in an insolvency proceeding, the applicable insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules for stockbroker liquidation proceedings under the [Code and SIPA] provide that all customer property [protected by the SEC's customer protection regime] is distributed *pro rata* among all customers in proportion to the dollar value of their total positions, rather than dividing the property on an issue-by-issue basis. For intermediaries that are not subject to the [Code and SIPA], other insolvency law would determine what distribution rule is applied.

As discussed above in paragraphs 1.32 through 1.36, in the case of an FCM's bankruptcy, the distribution of its customer property, including financial assets, such as cleared swaps, that it holds for its customers as their securities intermediary under Article 8, would be governed by Subchapter IV and Part 190; the property would be distributed *pro rata* among all customers in proportion to their allowed net equity claims.

US Federal book-entry security regulations. To the extent that securities credited to the customer account consist of bills, notes and bonds issued by the U.S. Treasury Department or securities issued by government-sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, US federal regulations may supersede the UCC with respect to certain matters. Such regulations define and use the terms "security entitlement" and "securities intermediary" in a manner that parallels the corresponding definitions in Article 8. *See* Section X of the S&C Memorandum.

Hague Convention. Section X of the S&C Memo discusses the treatment of a customer's futures and cleared swaps as "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**"). 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. The status of the cleared swaps as "securities" under the Hague Convention will be determined by the provisions of that treaty, whether or not the FCM and the customer make a financial asset election with respect to the customer's cleared swaps. The S&C Memo explains that the Hague Convention defines "securities" to include not only "shares" and "bonds," but also "other financial instruments or financial assets (other than cash), or any interest therein," and that while the Hague Convention does not define "financial instruments" or "financial assets," the *Explanatory Report on the Hague Convention on the Law Applicable to certain Rights in Respect of Securities Held with an Intermediary* "states that exchange-traded financial futures and options, and credit derivatives, '[c]learly fall[] within the definition.'" S&C Memo at 83.

[44] UCC Section 9-102(a) defines "**investment property**" as "a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity contract." "**General intangible**," as defined in UCC Section 9-102(a), is a residual

respect to the customer's futures and as securities intermediary with respect to the customer's cleared swaps. If the FCM has control of all security entitlements or commodity contracts carried in a securities account or commodity account, the 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

1.40 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 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.

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

1.41.1 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 may be 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. Perfection of the FCM's security interest in cash would cease when the cash is disbursed from the segregated account unless the FCM's control is maintained in some. However, when the cash is transferred to the FCM's omnibus customer margin account at a DCO or the FCM's account at a foreign futures broker, the DCO or foreign futures broker, by crediting the cash margin to the FCM's omnibus customer margin account, acknowledges that it controls the funds on behalf of the FCM, thereby granting the FCM control over the funds while credited to that account.

1.41.2 Furthermore, 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. Official Comment 4 to UCC Section 9-108 states that "given the broad definition of 'securities account' . . . a security interest in a securities account also includes all other rights of the debtor against the securities intermediary arising out of the securities account [including] credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement." Thus, the UCC acknowledges, in the case of a securities account, that cash balances credited to that account are an indivisible part of that account, perfection of a security interest in which is achieved when the security interest in the securities account is perfected. There is no reason that the same analysis would not apply to a commodity account.

1.41.3 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

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category of personal property that is not included in the other types of collateral (including investment property) defined in UCC Article 9. If, for some reason, the FCM and its customer did *not* make a financial asset election with respect to cleared swaps, then the customer's cleared swaps would be "general intangibles" under the UCC.

all cash credited thereto as a "financial asset," the customer will obtain a security entitlement to the cash and the FCM's security interest in such security entitlement will be perfected as long as the FCM has control over the account (as described in paragraph 1.39). If the FCM and customer elect to treat the cleared swaps credited to the customer's cleared swaps account as financial assets credited to a securities account maintained by the FCM as the customer's securities intermediary, but the parties do not make a financial asset election with respect to cash credited to the account, it is arguable that by obtaining control over the account and perfecting its security interest in the account, the FCM should perfect is security interest in all cash credited to the account as described in paragraph 1.41.2.

Securities Collateral

1.42 If the customer delivers margin in the form of securities, the FCM will credit the securities to the customer account, and if the customer account constitutes a securities account maintained for the customer by the FCM acting as the customer's securities intermediary, the customer will obtain security entitlement(s) to the securities. As the security entitlements are investment property (rather than general intangibles) for purposes of UCC Article 9, the FCM's security interest in them may be perfected by control, which the FCM has automatically by virtue of its status as the customer's securities intermediary.[45] UCC Section 9-314 provides that the security interest remains perfected until the FCM does not have control, *and* the customer is or becomes the entitlement holder; accordingly, rehypothecation or other disposition of the security entitlement does not affect the perfection of the FCM's security interest unless the customer once again has control of the security entitlement.[46]

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

[46] UCC § 9-314(c).

FCM's rights and practices with respect to repledge and rehypothecation. 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 rights are 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). Base account agreements also typically provide that the FCM is under no obligation to return to a customer the same securities it deposited as margin (*e.g.*, a security with the same ISIN/CUSIP number), but the FCM may agree to provide equivalent securities, if practicable. For example, if the customer deposited with the FCM 5-year US Treasuries, the FCM would endeavor to return 5-year US Treasuries if practicable, of the same aggregate value but not necessarily the same ISIN/CUSIP. Additionally, under the Customer Property Rules, when the FCM makes its daily computations of the amount of US futures customer funds required to be in Segregated Accounts, it is required, as a condition to offsetting any net deficit in a customer's futures account against the current market value of readily marketable securities credited to the account, to maintain a security interest in the securities "including a written authorization to liquidate the securities at the [FCM's] discretion." CFTC Rule 1.32(b). As noted in paragraph 1.36, the Customer Property Rules also permit the FCM to repledge customer securities margin to DCOs as margin to secure the FCM's obligations to the DCOs in respect of customer contracts cleared through the DCOs and afford the FCM significant flexibility to repledge a customer's securities margin to a DCO that does not clear the customer's contracts and to rehypothecate customer securities for cash in repo agreements.

When a customer deposits securities margin with the FCM, the customer will cause its securities intermediary to transfer the securities to the FCM's securities intermediary, which will credit a securities entitlement to the securities to the FCM's own securities account maintained by the intermediary. The FCM will also credit a securities entitlement to the securities to the customer account it maintains for the customer, which is a securities account maintained for the customer by the FCM as its securities intermediary to the extent that it relates to assets other than commodity contracts. If the FCM repledges the securities to a DCO, the FCM will cause the FCM's securities intermediary to transfer the securities to the DCO's securities intermediary, but the FCM will not debit the securities from the customer account. As a result, an imbalance may be created between the securities of a particular issue that are credited to the FCM's securities account maintained at the FCM's securities intermediary and the securities of that issue that are credited to the FCM's customer accounts. However, securities repledged to the DCO are held in segregation by the DCO and they continue to constitute segregated funds of the FCM. Similarly, if the FCM rehypothecates customer securities margin (*e.g.*, by means of repo transactions), the FCM will cause its securities intermediary to transfer the securities to the relevant transferee (or its securities intermediary) but the FCM will not debit the securities from the customer accounts. Similar to a repledge, the rehypothecation may create an imbalance between the securities of a particular issue credited to the FCM's securities account at its securities intermediary and the securities of that issue credited to its customer accounts. In contrast to repledged securities, however, the rehypothecated securities will not continue to constitute segregated funds of the FCM. But, as described in note 19, the FCM is required by the Customer Property Rules with respect to permitted investments to maintain the proceeds of the rehypothecation in segregation to ensure that there is sufficient value in the FCM's segregated funds to cover all customer claims, including in the FCM's bankruptcy.

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[47] 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 authority given to it under the CEA, 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

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Repledge and rehypothecation and FCM's duties as securities intermediary. The imbalances described above that result from the FCM's repledge and rehypothecation of customer securities would appear, at first blush, to be inconsistent with UCC Section 8-504(a), which imposes upon a securities intermediary a duty to obtain and maintain a financial asset "in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset." However, UCC Section 8-509 additionally provides that if a duty of a securities intermediary under Part 5 of Article 8, including a duty under UCC Section 8-504, is the subject of some "other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty." As the Official Comment to UCC Section 8-509 explains:

> [UCC Article 8] is not a comprehensive statement of the law governing the relationship between . . . securities intermediaries and their customers. Most of the law governing that relationship is the common law of contract and agency, supplemented or supplanted by regulatory law. [UCC Article 8] deals only with the most basic commercial/property law principles governing the relationship. Although [UCC Article 8 specifies] certain duties of securities intermediaries to entitlement holders, the point [of such specification] is to identify what it means to have a security entitlement, not to specify the details of performance of these duties. For many intermediaries, regulatory law specifies in great detail the intermediary's obligations on such matters as safekeeping of customer property . . . and the like. To avoid any conflict between the general statement of duties in [UCC Article 8] and the specific statement of intermediaries' obligations in such regulatory schemes, [UCC Section 8-509] provides that compliance with applicable regulation constitutes compliance with the duties specified in [UCC Article 8].

The Customer Property Rules constitute such a regulatory scheme. The FCM's compliance with the segregation requirements of the Customer Property Rules (including the requirement to maintain the proceeds of rehypothecation in segregation) satisfies the FCM's duty under UCC Section 8-504(a). Additionally, UCC Section 8-504(b) prohibits a securities intermediary from granting any security interests in a financial asset it is obligated to maintain pursuant to UCC Section 8-504(a), "[e]xcept to the extent otherwise agreed by its entitlement holder." The FCM's repledge of customer securities to a DCO is consistent with its duty under UCC Section 8-504(b) because it is authorized by the customer in its customer agreement. Thus, by complying with the Customer Property Rules and with the Customer Agreement, the FCM abides by its duties as a securities intermediary with respect to a customer's securities margin, including its duties pursuant to UCC Section 8-504.

Repledge and rehypothecation and customer's property interest. Official Comment 3 to UCC Section 9-314 states that "[i]n a transaction in which a secured party who has control grants a security interest in investment property or sells outright the investment property, by virtue of the debtor's consent or applicable legal rules, a purchaser from the secured party typically will cut off the debtor's rights in the investment property or be immune from the debtor's claims." Official Comment 3 continues, "If the investment property is a security, the debtor normally would retain no interest in the security, and a claim of the debtor against the secured party for redemption . . . or otherwise with respect to the security would be a purely personal claim." Official Comment 3 adds that "[i]f the investment property transferred by the secured party is a financial asset in which the debtor had a security entitlement credited to a securities account maintained with the secured party as a securities intermediary, the debtor's claim against the secured party could arise as a part of its securities account notwithstanding its personal nature [and] would be analogous to a credit balance in the securities account [assuming the parties have not made a financial asset election with respect to cash credited to the customer account], which is a component of the securities account even though it is a personal claim against the intermediary . . . ." Kettering, however, posits that an alternative view might be that, following the repledge or sale by the secured party/securities intermediary, the debtor has a security entitlement to the secured party's redemption obligation, which is its personal obligation, to the debtor. *See* Kettering, *supra* note 34, at 219.

[47] The FCM's obligation to follow the customer's instructions is not unconditional even before the customer's default. 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.

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 CEA and the terms of the customer agreement, 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.

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. 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 contracts, risk-reducing contracts or hedging contracts, and by valuing any contracts 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**").[48] 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 positions in futures or cleared swaps contracts. Each of the methods seeks to "remove" or "close out" the position from the relevant omnibus customer positions account (whether at a DCO or FCO).

2.5.1 For example, subject to DCO or FCO rules and operational feasibility, a FCM may close out an open position by:

(i) offsetting it with an equal and opposite contract (an "**offsetting contract**") executed by or on behalf of the FCM (or by the FCM's foreign futures broker upon the instruction of the FCM), which contract 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

[48] 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.

account maintained by the FCO) 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 contract; or

(ii) causing the relevant DCO or FCO 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 FCO) by book-entry transfer of 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.

2.5.2 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 contracts in order to hedge or otherwise manage risks it incurs in connection with the liquidation of the customer account. These hedging contracts 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 FCO, in each case, as necessary.

2.5.3 Under 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 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 the 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 rights and interests in respect of the contracts to effect their close-out or liquidation.[49]

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

[49] 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 1.37, the FCM also has a perfected security interest in the customer's rights and interests in respect of the 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.

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.[50]

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 customer 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 customer 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, including 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.[51]

2.10 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.[52] If the customer account includes only one account class, then there is a single Determination of Account. If the customer 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

2.11 Consistent with the status of the customer account as a mutual open account, the customer account is established on the basis that the individual debits and credits in the customer 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 customer account, the final cash balance in the customer account constitute a single indivisible debt claim by one

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[50] 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 rights and interests in respect of collateral 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 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)).

[51] 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 apply such funds to permitted uses, including to guarantee, transfer and settle the customer's contracts.

[52] 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 customer 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 1.28 through 1.31.

party against the other, as discussed in paragraph 1.6. Accordingly, the FCM's Determination of Account may 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 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 class within a customer account, and to the calculation of the final cash balance for all the account classes on a combined basis.[53]

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

2.12 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 account to satisfy the customer's obligations in respect of the debits made to the customer 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.

2.13 As noted in paragraph 1.37, the FCM is granted a security interest in the customer Collateral, which includes any cash credited to the customer account (including the customer 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 account, or the customer 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.

2.14 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 1.40, 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 customer 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.

2.15 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,

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[53] Stated differently, under this characterization, the Determination of Account is the calculation of a running-account balance of all debits and credits to the customer account, which is a determination of the overall value of the single course of dealing between the FCM and the customer represented by the customer 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 contracts 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. As noted in paragraph 2.8, 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 segregated funds or separate account funds of the account class with the credit balance. In other words, by debiting the customer account for the debit balance of one account class, 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.[54]

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

2.16 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 contracts) as "belonging to" the customer, or the characterization of the FCM as a "statutory trustee," would prevent the FCM from debiting the customer account of an insolvent customer or setting off customer funds credited to the customer 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:

2.16.1 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[55] 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.

2.16.2 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 1.37. 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.

2.16.3 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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[54] 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.

[55] 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 positions of itself and its other customers by 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.

Annex 2
Instructions

Version 6-12-25

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

Dear Sir or Madam:

On behalf of the International Swaps and Derivatives Association, Inc. ("**ISDA**") and the Futures Industry Association ("**FIA**"), I write this letter to request that your firm prepare for ISDA and FIA a legal opinion regarding (1) the enforceability under the laws of [ ] ("**your jurisdiction**") 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 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 your jurisdiction (the "**Customer**") and (2) the validity, perfection and enforcement of the security interest granted the FCM by the Customer under the Covered Agreement in the Collateral (as defined below).

Capitalized terms used but not defined in this letter have the meanings given such terms in the memorandum of law, dated November 17, 2021, delivered by Sullivan & Cromwell LLP to ISDA/FIA (the "**S&C Memo**"), which provides an overview of the FCM clearing model in Sections I through XI (and which can be found here: Microsoft Word - FIA-ISDA 2021 Memorandum 4829-5794-1199 v.11.docx), and the annex attached to this letter (the "**Summary Annex**"), which provides a high-level overview and summary of the main concepts covered, conclusions reached and certain factual assumptions taken in the S&C Memo. We are providing the S&C Memo and Summary Annex to help you understand the FCM clearing model and applicable US laws and regulations.

If a Customer clears only Futures, the Covered Agreement will consist of a customer account agreement (the "**Base Account Agreement**"). If the Customer clears only Cleared Swaps or both Futures and Cleared Swaps, the Covered Agreement will consist of a Base Account Agreement together with a Cleared Derivatives Addendum substantially in the form published by FIA and ISDA in 2012 or 2018 (either, the "**CDA**"). As each of the Base Account Agreement and CDA has its own remedial provisions, your opinion should address the enforceability of the provisions of each of the Base Account Agreement and CDA that, upon an Event of Default with respect to the Customer, provide the FCM the right to engage in Position Liquidation, Margin Liquidation and a Determination of Account to determine a single balance of account as between the FCM and the Customer. As the FCM's exercise of the remedial provisions may involve the enforcement of the FCM's security interest in the Customer's rights and interests in respect of the Collateral, your opinion should also address the validity, perfection and enforcement of the FCM's security interest. The enforceability of the remedial provisions and the validity, perfection and enforcement of the security interest are of importance to FCMs that clear Futures and/or Cleared Swaps pursuant to Covered Agreements as a matter of both credit risk assessment and considerations of capital adequacy.

In connection with the preparation of your opinion, we enclose for your information the two forms of the CDA referred to above and a redline comparing the two. Your opinion should be based on the assumptions describing a CDA below rather than either published form of CDA, but you may assume that both of these

published forms meet those assumptions. Please note that there is not an industry-standard published form of Base Account Agreement.

Scope of Opinion

Our members have found that it is important (for example, for ensuring the enforceability of the remedial provisions for regulatory capital purposes) that the scope of the opinion be clear and certain, both in terms of the types of transactions covered by the opinion and the types of customers falling within the scope of the opinion.

Covered Transactions/Contracts

As explained above, the types of transactions that may be cleared for the Customer pursuant to the Covered Agreement include US Futures, Foreign Futures and Cleared Swaps (together, "**Covered Transactions**" or "**Covered Contracts**").

We do not describe herein the scope of transactions that may be Futures or Cleared Swaps (other than the requirements reflected in the definitions set out above).

Types of Customers to be Covered in your Opinion

Please indicate the types of Customers covered by your opinion in an appendix to your opinion substantially in the form of Appendix A to this letter. Your opinion should, at a minimum, cover customers falling within the categories "Bank/Credit Institution," "Corporation" and "Investment Firm/Broker Dealer," as described in Appendix A to this letter, and any other categories of entities covered in your netting and collateral opinions with respect to the ISDA Master Agreement and related credit support documents.

Appendix A sets out a series of commercial descriptions. We understand that these descriptions may not correspond precisely to legal categories under the laws of your jurisdiction. Please indicate, therefore, for each Appendix A category covered by your opinion, the precise legal form for each customer type falling within that category that is covered by your opinion. Please include, if relevant, any naming convention or rule that would help a reader of the opinion to identify and classify the entity (for example, the inclusion of a designation in the legal name of the entity such as "S.A.," "N.V.," "A.G.," "S.p.A," "Plc," "Limited" or the like or the mandatory inclusion of a word or words in the name, for example, "Bank" in relation to banks or "Insurance" or "Assurance" in relation to insurance companies).

In relation to each Appendix A category covered by your opinion, if your opinion does not cover all relevant legal forms of customer that are capable of falling within that category in your jurisdiction, please indicate clearly what is excluded. For example, if your opinion covers corporations that fall within the category "Investment Firm/Broker Dealer" but not partnerships that fall within that category, then please indicate that fact.

Finally, we understand that some types of customers may not fall clearly within only one of the category types in Appendix A or otherwise may be difficult to classify. As above, please indicate the precise legal form and any relevant naming conventions or mandatory naming rules for each additional category covered by your opinion.

An example of an entity difficult to classify would be a German Förderbank (development bank), which is owned by the Sovereign (the Federal Republic of Germany) or by a State of a Federal Sovereign (that is, a Bundesbank, such as Nordrhein-Westfalen). Therefore, it would be a Sovereign-Owned Entity. It would

also be a Bank/Credit Institution if its core business involves taking deposits and making loans. An entity type that is difficult to classify should be dealt with in your opinion as an additional category.

It is most helpful if all information relating to customer scope is presented in the appendix to your opinion in table form and the body of the opinion refers to the appendix without a separate discussion of customer scope. If you feel it is necessary to include a discussion of customer scope within the text of the opinion, please carefully reconcile it with the information presented in Appendix A so that the customer scope of the opinion is clear.

Additional customer types covered by your opinion and for which there is no category set out in the standard Appendix A should be added in additional rows to your appendix.

Assumptions

You may assume for purposes of your opinion that the statements contained in this letter, the Summary Annex and the S&C Memo are true and correct.

Additional assumptions you should take for purposes of your opinion are specified below, including in Sections I.A and II.B. If you make any assumptions other than those specified below, please state them explicitly in your opinion.

Instructions Regarding Analysis of Position Liquidation, Margin Liquidation and Determination of Account

As explained in Section XI.A.2 of the S&C Memo and paragraphs 2.3, 2.4, 2.9 and 2.10 of the Summary Annex, upon an Event of Default with respect to the Customer, the remedial provisions of the Base Account Agreement typically provide that the FCM would have a right to, among other things, (1) close out or otherwise liquidate the Customer's open positions in its Covered Contracts, and hedge risk incurred by the FCM in connection with the Event of Default, by any reasonable method, including by means of entering into offsetting contracts, risk-reducing contracts or hedging contracts, and by valuing any contracts 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**"). In connection with exercising Position Liquidation and Margin Liquidation, the FCM would make a determination of a single balance or net termination amount due from one party to the other in respect of each Account Class and all Account Classes on an aggregate basis (a "**Determination of Account**"). The CDA provides the FCM with comparable remedies upon the occurrence of an Event of Default.

Position Liquidation

The Position Liquidation methods available to the FCM to close out or otherwise liquidate the Customer's open positions in Covered Contracts are described in Section XI.A.2 of the S&C Memo and paragraph 2.5 of the Summary Annex.

Part I Analysis – Position Liquidation by Contractual Enforcement

As explained in Sections XI.A.2 and XI.B.1 of the S&C Memo, the FCM could effect the close-out or liquidation of the Customer's open positions in Covered Contracts credited to the FCM's omnibus customer position accounts at DCOs and Foreign Futures Brokers by exercising its contractual rights under the rules

of such DCOs and provisions of its clearing agreements with such Foreign Futures Brokers that the FCM has by virtue of being the legal owner of, and the party in contractual privity with such DCOs and Foreign Futures Brokers, under the Covered Contracts cleared for the Customer. Additionally, in engaging in such Position Liquidation, the FCM would not act in its capacity as the Customer's agent. Rather, upon the Event of Default, the FCM would be viewed as acting in its principal capacity as it would no longer be required under the Covered Agreement to follow the Customer's instructions and would be permitted to act in its own interest (subject to any requirements of the Covered Agreement, which may require the FCM to act in a commercially reasonable manner). Such Position Liquidation would not be a foreclosure, and the FCM would not need to enforce its security interest in the Customer's rights and interests in respect of the Covered Contracts.

Your responses to questions I.B.2 and I.B.7 in Part I below should analyze Position Liquidation assuming the FCM would seek to characterize itself as (i) effecting the closeout or liquidation of the Customer's open positions by exercising its rights provided to it in the rules of a DCO or the clearing agreement with a Foreign Futures Broker as the legal owner of, and the party in contractual privity with the DCO or Foreign Futures Broker under, the Customer's Covered Contracts and (ii) acting in a principal capacity and not as the Customer's agent in exercising such rights.

In providing your responses to the Part I questions, please confirm whether such characterization would be recognized by a court in your jurisdiction and explain the reasoning for your conclusion. For example, would the FCM's characterization as legal owner of, and the party in contractual privity with the DCO or Foreign Futures Broker under, the Customer's Covered Contracts be subject to recognition by a court in your jurisdiction of the FCM as holding the Covered Contracts as an "agent-trustee," and if that were the case, would such recognition depend upon the court concluding that there would need to be a valid trust under either New York law or the law of your jurisdiction? Could the characterization of legal ownership and contractual privity be viewed as based on an alternative arrangement, such as a commission agency?

Part II Analysis – Position Liquidation by Collateral Enforcement

As noted in paragraph 2.7 of the Summary Annex, the FCM also has a perfected security interest in the Customer's rights and interests in respect of the Customer Account and the property credited thereto, including the Customer's open positions in the Covered Contracts cleared for it, and the FCM could alternatively seek to characterize itself as effecting the close-out or liquidation of the Covered Contracts by electing to exercise its rights as a secured party to enforce its security interest and sell, liquidate or otherwise dispose of the Customer's Covered Contracts.

Your responses to the questions posed in Section C of Part II below should analyze Position Liquidation assuming it is viewed as involving the FCM's enforcement of its security interest to sell, liquidate or otherwise dispose of the Customer's Covered Contracts.

Margin Liquidation

You may assume for purposes of your opinion that Margin Liquidation refers to the sale, liquidation or other disposition of securities only (and not also to any non-cash assets other than securities).

Part I Analysis – Margin Liquidation by FCM's Exercise of its Permitted Uses Rights Under Customer Property Rules

As explained in Sections XI.A.2 and XI.B.2 of the S&C Memo and paragraph 2.8 of the Summary Annex, Margin Liquidation may be viewed as involving the FCM's exercise of its rights under the applicable Customer Property Rules (which have been characterized by US courts and the CFTC as operating to

impose a "statutory" trust over an FCM's Customer Funds) to withdraw and apply Customer Funds for Permitted Uses (the FCM's "**Permitted Uses Rights**"), including to satisfy amounts due to a DCO, or to other parties, in the course of liquidating a Customer's Covered Contracts. This process would not be a foreclosure, and the FCM would not need to enforce its security interest in the Customer's rights and interests in respect of Collateral consisting of securities to effect their liquidation or use them in this manner.

Your responses to questions I.B.3 and I.B.7 in Part I below should analyze Margin Liquidation assuming the FCM would seek to characterize itself as effecting Margin Liquidation based on the exercise of its Permitted Uses Rights under the Customer Property Rules rather than the FCM's enforcement of its security interest in Customer's rights and interests in respect of Collateral consisting of securities.

Your responses should confirm whether a court in your jurisdiction would recognize such characterization and should explain the reasoning for such conclusion. For example, would such recognition be based on the FCM's status as legal owner of the Segregated Funds or Separate Account Funds of the applicable Account Class? Would such legal ownership depend on whether there was a statutory trust over Customer Funds under US law that is recognized as a valid trust under the laws of your jurisdiction?

Part II Analysis – Margin Liquidation by Collateral Enforcement

As explained in Section XI of the S&C Memo and paragraph 2.8 of the Summary Annex, the FCM may also effect Margin Liquidation by exercise of its rights as a secured party to enforce its security interests in the Customer's rights and interests in respect of Collateral consisting of securities and sell, liquidate or otherwise dispose of such securities.

Your responses to questions posed in Section C of Part II below should analyze Margin Liquidation assuming the FCM would seek to characterize itself as effecting Margin Liquidation based on the FCM's enforcement of its security interest in Customer's rights and interests in respect of Collateral consisting of securities rather than the exercise of its Permitted Uses Rights.

Determination of Account

As explained in Sections XI.A.2 and XI.A.3 and paragraph 2.11 of the Summary Annex, a Determination of Account by the FCM may be viewed, consistent with the intention of the parties that the Customer Account constitute a mutual, open and running account, as an accounting procedure to determine a running account balance that does not involve netting or set-off of distinct independent obligations of the parties or the FCM's enforcement of its security interest in the Customer Account or cash credited thereto to bring about a single debt claim of one of the parties. However, if the intention of the parties is not honored, the Determination of Account could also be viewed as involving netting or set-off (of, for example, the respective obligations of the FCM to account for trading gains or to repay the positive cash balance of the Customer Account against the Customer's obligations to pay an amount equal to trading losses and other chargeable costs) or enforcement of the FCM's security interest in the rights and interests of the Customer in the Customer Account or cash credited thereto or otherwise due to the Customer.

Your responses to questions I.B.4 and I.B.7 should analyze Determination of Account assuming the FCM would seek to characterize the Determination of Account either as (i) a determination of a running account balance that is an accounting procedure not involving netting or set-off or enforcement of the security interest or (ii) involving netting or set-off. Would a court in your jurisdiction recognize each such characterization. If a particular characterization would not be recognized or could be challenged for any reason (or such recognition would depend on whether there was a statutory trust over Customer Funds under U.S. law that is recognized as a valid trust under the laws of your jurisdiction), please provide further detail and explain the reason for this.

Your responses to questions posed in Part II below should assume the FCM would seek to characterize a Determination of Account as involving the enforcement of its security interest in the Customer's rights and interests in the Customer Account and the cash credited thereto.

PART I

POSITION LIQUIDATION, MARGIN LIQUIDATION AND DETERMINATION OF ACCOUNT

A. *Additional Assumptions*

1. The FCM and Customer enter into a Covered Agreement (consisting of a Base Account Agreement and CDA) pursuant to which the FCM maintains one or more accounts in the name of the Customer on the FCM's books and records, and the Customer authorizes the FCM, to execute, clear and carry US Futures, Cleared Swaps and/or Foreign Futures on behalf of the Customer (individually or collectively, the "**Customer Account**" or the "**Account**").

2. Each of the Base Account Agreement and the CDA is governed by New York law.

3. On the basis of the terms and conditions of the Covered Agreement and other relevant factors and acting in a manner consistent with the intentions stated in the Covered Agreement, over time, open positions are established for the Customer in Covered Contracts that are cleared and carried in or credited to the Customer Account.

4. Some of the Covered Contracts cleared for the Customer provide for an exchange of cash and others provide for the physical delivery of shares, bonds or commodities in exchange for cash.

5. After commencing clearing and while the Customer has open positions in Covered Contracts, the Customer, which is organized in your jurisdiction, becomes the subject of a formal bankruptcy, insolvency, liquidation, reorganization, administration or comparable proceeding (collectively, the "**insolvency**") under the insolvency laws of your jurisdiction and, as a result, an Event of Default occurs under each of the Base Account Agreement and CDA.

If there are different types of insolvency proceedings under the laws of your jurisdiction (for example, bankruptcy or liquidation proceedings where an entity does not emerge as a going concern, on the one hand, and a reorganization or administration proceeding where an entity is restructured and does continue as a going concern, on the other hand), please briefly describe the different types of proceedings and answer each question with respect to each such proceeding.

6. Subsequent to the commencement of the insolvency, either the Customer or an insolvency official seeks to challenge or otherwise prevent Position Liquidation, Margin Liquidation or a Determination of Account (by, for example, seeking to assume the profitable open positions, and to reject unprofitable open positions, in Covered Contracts cleared for the Customer.

B. *Questions*

1. Would the parties' agreement on governing law and submission to jurisdiction set out in each of the Base Account Agreement and CDA be given effect by a court in your jurisdiction, and what would be the consequences if they were not?

2. 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 2.5 of the Summary Annex be recognized and upheld by a court in your jurisdiction? If a particular Position Liquidation method would either not be upheld or could be challenged, please provide further detail and explain the reason for this. Are there any circumstances in your jurisdiction, including any moratorium, stay, freeze or other consequence of the commencement of an insolvency proceeding, that might affect the FCM's ability to exercise Position Liquidation?

3. Would the Margin Liquidation provisions of each of the Base Account Agreement and CDA be enforceable under the laws of your jurisdiction and the FCM's Margin Liquidation in respect of each Account Class be recognized and upheld by a court in your jurisdiction? Are there any 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 Margin Liquidation?

4. Would the Determination of Account provisions of each of the Based Account Agreement and CDA be enforceable under the laws of your jurisdiction and the FCM's Determination of Account in respect of (a) each Account Class and (b) all Account Classes on a combined basis be recognized and upheld by a court in your jurisdiction? Are there any 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 a Determination of Account in respect of an Account Class or the overall Customer Account (comprising the three Account Classes)?

6. Assuming the parties have entered into the Covered Agreement, an Event of Default has occurred with respect to the Customer 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:

(a) Outside the context of insolvency proceedings, 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?

(b) Can a claim for the cash balance or net termination amount be proved (*i.e.*, filed) in insolvency proceedings in your jurisdiction without conversion into the local currency?

If in either case the claim must be converted to local currency for purposes of enforcement or proof in insolvency proceedings, please set out the rules governing the timing and exchange rate for such conversion.

7. Are there any other local 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?

PART II

VALIDITY, PERFECTION AND ENFORCEMENT OF FCM'S SECURITY INTEREST IN CUSTOMER'S RIGHTS AND INTERESTS IN RESPECT OF COLLATERAL

A. *Fact Patterns Regarding Location of the Customer and Collateral*

Please address the questions below in your opinion even if you have concluded (a) in your response to question I.B.3 above, that Margin Liquidation would be recognized by a court in your jurisdiction as the FCM's exercise of its Permitted Uses Rights under the Customer Property Rules and (b) in your response to question I.B.4 above, that a Determination of Account would be characterized as contractual accounting or as involving netting or set-off.

We set out below three principal fact patterns we would like you to consider in answering the questions posed in Section C below.

The three principal fact patterns concern (a) whether or not the Location (as defined below) of the Customer is in your jurisdiction and (b) whether or not the Location of the Collateral (as defined below) is in your jurisdiction.

In particular, when responding to each question, could you please distinguish between the following three fact patterns:

I. The Location of the Customer is in your jurisdiction and the Location of the Collateral is outside your jurisdiction.

II. The Location of the Customer is in your jurisdiction and the Location of the Collateral is in your jurisdiction.

III. The Location of the Customer is outside your jurisdiction and the Location of the Collateral is in your jurisdiction.

For the foregoing purposes:

(a) the "Location" of the Customer is in your jurisdiction if it resides, is incorporated or otherwise organized in your jurisdiction and/or if it has a branch or other place of business in your jurisdiction; and

(b) the "Location" of Collateral is the place where an asset of that type is located under the private international law rules of your jurisdiction.

"**Located**" when used below in relation to a Customer or any Collateral should be construed accordingly.

In relation to (a), if under the laws of your jurisdiction, the Location of an entity would be determined on a different basis and this would affect your conclusions, please set out the relevant rules and explain their consequences.

In considering fact patterns I and II, please indicate whether and, if so, in which circumstances it makes a difference whether the Customer (i) is incorporated or otherwise organized in your jurisdiction or (ii) is a foreign entity with a branch or other place of business in your jurisdiction.

If the location of the FCM would affect your response to any question, please make this clear in the relevant response.

B. *Additional Assumptions*

Please assume the same facts as set forth in Section A of Part I above (as applicable) with the following modifications:

1. Please assume that under the terms of the Covered Agreement, the Customer grants to the FCM a first-priority security interest in, lien on and right of set-off against, all the rights and interests of the Customer in respect of the following types of property, whether at the time of the grant or thereafter existing ("**Collateral**"): (1) the Customer Account (*i.e.*, the account in the name of the Customer that is maintained

by the FCM on its books and records), (2) the Covered Contracts carried in or credited to the Customer Account, (3) cash credited to or held in the Customer Account and (4) the types of securities identified below that are credited to the Customer Account and that are Located or deemed Located either (i) in your jurisdiction or (ii) outside your jurisdiction.

2. Please assume that Collateral in the form of cash is denominated in a freely convertible currency and is credited to an account (as opposed to physical notes and coins) under the "control" of the FCM for purposes of the New York Uniform Commercial Code (the "**UCC**"), as described in paragraph 1.41 of the Summary Annex. Additionally, please assume the following:

As explained in Section X of the S&C Memo and paragraphs 1.14, 1.16, 1.18, 1.19, 1.20 and 1.28, when the Customer delivers cash margin to the FCM, the FCM credits the cash to the Customer Account (which is not a deposit account, but rather a securities account, commodity account or hybrid securities/commodity account on the books and records of the FCM) and deposits the cash in one or more deposit accounts maintained in the name of the FCM with the FCM's settlement banks (which are banks or trust companies that satisfy CFTC requirements). Such deposit accounts are segregated omnibus accounts in which the cash delivered by the Customer is commingled with cash margin delivered to the FCM by its other customers in the same account class (as well as the FCM's own funds representing its residual interest, which is a buffer intended to ensure the FCM has segregated or set aside sufficient funds to cover the positive net liquidating equities of accounts of customers in the same account class). Such deposit accounts are titled under account names that clearly identify the cash therein as belonging to the FCM's customers in the applicable account class. The FCM's settlement banks maintaining such deposit accounts are permitted to comply with the FCM's withdrawal instructions without further inquiry as to their compliance with the Customer Property Rules (so long as the depositories does not have notice of or actual knowledge of a potential violation by the FCM), and the FCM's customers have no right to access the accounts.

Under the Customer Property Rules, the FCM is expressly permitted to use funds held in such deposit accounts to, among other things, margin or secure the obligations of the FCM to DCOs or Foreign Futures Broker in respect of Covered Contracts of the Customer and/or other customers in the applicable Account Class that are cleared through the DCOs or Foreign Futures Brokers. When cash is withdrawn from such deposit accounts and transferred to DCOs or Foreign Futures Brokers, the transferred cash is credited to omnibus customer margin accounts maintained by the DCOs or Foreign Futures Brokers on their books and records. Such accounts may not be accessed by customers of the FCM.

Additionally, as explained in paragraphs 1.16 and 1.20 of the Summary Annex, under the Customer Property Rules related to permitted investments of customer funds (the "**Permitted Investment Rules**"), the FCM may invest (including by means of reverse repurchase transactions) Customer Funds consisting of cash in certain types of permitted investment specified by the CFTC. The FCM may retain as its own profits resulting from such permitted investments, but it is required to segregate them and it must bear (and not allocate to customers) any losses with respect to them.[1]

3. Please assume that the any securities provided by the Customer as Collateral are held in one of the following forms, are denominated in either the currency of your jurisdiction or any freely convertible currency and consist of (i) corporate debt securities whether or not the issuer is organized or located in your

[1] As explained in paragraphs 1.28 and 1.30 of the Summary Annex, neither transfers of customer cash to DCOs and Foreign Futures Brokers nor investment of customer cash in permitted investments pursuant to the Permitted Investment Rules results in adjustments to the cash balance of the Customer Account. The Customer Account's cash balance is adjusted when (i) trading gains or losses are realized in respect of its Covered Contracts when they are closed or settled, (ii) cash is delivered by the Customer to the FCM or is withdrawn by the Customer from the Customer Account, (iii) the Customer's securities margin if liquidated (other than in connection with making permitted investments) and (iv) any other amounts due to the FCM (*e.g.*, commissions and fees) or due to the Customer (*e.g.,* interest) under the Covered Agreement are debited from or credited to the Account.

jurisdiction; (ii) debt securities issued by the government of your jurisdiction or another jurisdiction; (iii) debt securities issued by multilateral development banks and international organizations; and (iv) equity securities whether or not the issuer is organized or located in your jurisdiction:

(i) directly held bearer securities: by this we mean 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 (that is, not held by the FCM indirectly through an intermediary (as defined below));

(ii) directly held registered securities: by this we mean 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 securities: by this we mean 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); or

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

Our expectation is that the FCM will normally hold securities in the form of intermediated securities rather than directly in one of the three forms mentioned in (i), (ii) and (iii) above.

You should assume that in this case, and as explained in footnote 46 of the Summary Annex, when the Customer delivers margin to the FCM in the form of intermediated securities, the Customer will cause its intermediary to transfer the securities to the FCM's intermediary, which will credit them to the securities account maintained by the intermediary for the FCM, and the FCM will credit the securities to the Customer Account. As the FCM and Customer typically agree in the Covered Agreement to treat the Customer Account as a "securities account" maintained for the Customer by the FCM as the Customer's "securities intermediary," the Customer will obtain "security entitlement(s)" to the securities when they are credited to the Customer Account (as each such term is defined under Article 8 of the UCC). The security interest granted by the Customer to the FCM is in such security entitlement(s).

As explained in paragraph 1.36 and footnote 46 of the Summary Annex, under the Customer Property Rules, the FCM has significant flexibility to repledge, rehypothecate or otherwise dispose of customers' securities margin, subject in all cases to compliance with the segregation and other requirements of the Customer Property Rules. For example, with the Customer's agreement, the FCM may repledge securities margin delivered by the Customer to a DCO to secure the FCM's obligations to the DCO in respect of contracts cleared through the DCO for the Customer and/or for other customers of the FCM in the same Account Class (for example, securities deposited with the FCM by the Customer may repledge such securities to DCOs that do not clear the Customer's Covered Contracts, so long as the contracts at the DCO secured by the securities are in the same Account Class as the Customer's Covered Contracts). Also, under the Permitted Investment Rules, with the Customer's agreement, the FCM may rehypothecate (including by means of securities repurchase agreements) the Customer's securities margin for cash and may retain for itself the profits resulting from such permitted investments (but the FCM must segregate the

rehypothecation proceeds and must bear (and not allocate to any customers) any losses in respect thereof). Additionally, under the Customer Property Rules, if the FCM wishes to offset any net deficit in the Customer's Futures Account against the current market value of securities credited to the Account in its daily segregation computations, the FCM must have written authorization from the Customer to liquidate the securities in the FCM's discretion. You should assume that the Covered Agreement grants the FCM broad rights to repledge and rehypothecate the Customer's securities Collateral, subject to "applicable law" (which includes the Customer Property Rules), and to liquidate the securities in its discretion.[2]

4. Please note the following point regarding substitution of Collateral consisting of cash or securities. We understand that Base Account Agreements typically provide that, following closure of an open position by a customer, a FCM is under no obligation to return the same assets (*e.g.*, a security with the same ISIN/CUSIP number) posted by the customer, but the FCM may agree to provide equivalent assets, if practicable. For example, if the customer posted 5-year treasuries, the FCM would endeavor to return 5-year treasuries if practicable, but not necessarily the same ISIN/CUSIP. In some cases, the FCM might agree to a more stringent obligation to return equivalent assets, if practicable. However, it is not market practice for a Base Account Agreement to provide for an unqualified obligation on a FCM to return the same asset (contrast this position with paragraph 4(d) of either the 1994 ISDA Credit Support Annex (Bilateral Form) or the 1995 ISDA Credit Support Deed (Bilateral Form – Security Interest)).

We also understand that, as a matter of market practice, FCMs often offer their customers the ability to manage the collateral posted by the customer, for example by allowing the customer to post 10-year treasuries and returning 5-year treasuries to the customer. However, this is purely a matter of market practice, not a right of the customer explicitly provided in the agreement.

As Base Account Agreements typically do not include a right to substitute collateral, this letter does not include a question regarding the effect of substitution rights on the validity, continuity, perfection or priority of the security interest. However, please let us know if you think the market practice described above raises any questions that should be addressed in the opinion.

5. In the case of questions II.C.11 through II.C.14 below, if relevant, please also assume that after the 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 Customer, and/or, if applicable, the FCM has designated a date to begin closing out or otherwise liquidating the Customer's open positions in Covered Contracts cleared for it as a result thereof (however, an insolvency proceeding has not been instituted, which is addressed separately in Additional Assumption II.B.6 and questions II.C.15 through II.C.17 below).

6. In the case of questions II.C.15 through II.C.17 below, if relevant, please assume that the Customer has become subject to insolvency proceedings in your jurisdiction.

C. *Questions*

Validity and perfection of the security interest

1. Under the laws of your jurisdiction, what law governs the contractual aspects of the security interest in the Customer's rights and interests in respect of the various types of Collateral? Would the courts of

[2] As explained in footnote 46 of the Summary Annex, the FCM does not debit securities from the Customer Account when they are repledged to a DCO or Foreign Futures Broker or rehypothecated pursuant to the Permitted Investment Rules. The FCM debits securities from the Customer Account when (i) they are returned to the Customer or (ii) they are liquidated (including in connection with Margin Liquidation).

your jurisdiction recognize the validity of a security interest created under the Covered Agreement, assuming it is valid under New York law (as the governing law of the Covered Agreement)?

2. Under the laws of your jurisdiction, what law governs the proprietary aspects of the security interest in the Customer's rights and interests in respect of the different types of Collateral (*i.e.*, the formalities required to protect the security interest against competing claims) granted by the Customer (for example, the law of the jurisdiction of incorporation or organization of the Customer, the jurisdiction where the Collateral is Located (or deemed Located), the jurisdiction of the location of the FCM's intermediary or the jurisdiction of the location of the FCM as the Customer's securities intermediary, in relation to Collateral in the form of intermediated securities)? What factors would be relevant to this question? If the Location (or deemed Location) of the Collateral is the determining factor, please briefly describe the principles governing such determination under the law of your jurisdiction with respect to the different types of Collateral. If relevant, please describe how the laws of your jurisdiction apply to each form in which securities Collateral may be held as described in Additional Assumption II.B.3 above.

3. Would the courts of your jurisdiction recognize a security interest in the Customer's rights and interests in respect of the different types of Collateral? In answering this question, please bear in mind the different forms in which securities Collateral may be held, as described in the Additional Assumption II.B.3 above. Please indicate, in relation to cash Collateral, if your answer depends on the Location (or deemed Location) of the Customer Account or the account in which the relevant deposit obligations are recorded and/or upon the currency of those obligations.

4. What is the effect, if any, under the laws of your jurisdiction of the fact that the amount secured or the amount of the Collateral subject to the security interest will fluctuate under the Covered Agreement (including as a result of establishing open positions in 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 Collateral (*i.e.*, cash and securities Collateral not yet delivered to the FCM and open positions not yet established in Covered Contracts at the time of entry into the Covered Agreement)?

(c) Is there any difficulty with the concept of creating the 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 Customer with the FCM?

(d) Is it necessary under the laws of your jurisdiction for the amount secured by the security interest to be a fixed amount or subject to a fixed maximum amount?

(e) Is it permissible under the laws of your jurisdiction for the FCM to hold Collateral in excess of its actual exposure to the Customer under the Covered Agreement?

In relation to (a), it is understood that the security interest in the Customer's rights and interests in respect of any specific Collateral would only be relevant in relation to future obligations, if ever, at the time such future obligations arise and then only in relation to Collateral held at that time. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the security interest as security for such obligations or whether the security interest would take effect in relation to those future obligations without further action by either party.

In relation to (b), it is understood that the security interest in the Customer's rights and interests in respect of the different types of Collateral to be delivered at some point in the future after the time of entry into the Covered Agreement would not take effect in relation to such Collateral until it had been delivered to the FCM in accordance with the Covered Agreement. This question concerns whether it would be necessary for either party to perform any action at such time in order to ensure the effectiveness of the security interest in the Customer's rights and interests in respect of such Collateral or whether the security interest in relation to the Customer's rights and interests in respect of such Collateral would take effect without further action (other than the delivery) by either party.

In relation to (c), you may assume that each specific delivery to the FCM and return by the FCM of Collateral consisting of cash or securities under the Covered Agreement from time to time would be properly recorded by the FCM, so that, while the pool of Collateral would change from time to time, at any specific time the composition of the pool of Collateral could be clearly identified by the FCM.

5. Assuming that the courts of your jurisdiction would recognize the security interest in the Customer's rights and interests in respect of each type of Collateral, is any action (filing, registration, notification, stamping, notarization or any other action or the obtaining of any governmental, judicial, regulatory or other order, consent or approval) required in your jurisdiction to perfect the security interest? If so, please indicate what actions must be taken and how such actions may differ, if at all, depending upon the type of Collateral in question.

6. If there are any other requirements to ensure the validity or perfection of the security interest in the Customer's rights and interests in respect of each type of Collateral, please indicate the nature of such requirements. For example, is it necessary as a matter of formal validity that the Covered Agreement be expressly governed by the law of your jurisdiction or translated into any other language or for the Covered Agreement to include any specific wording? Are there any other documentary formalities that must be observed in order for the security interest in the Customer's rights and interests in respect of any type of Collateral to be recognized as valid and perfected in your jurisdiction?

7. Assuming that the FCM has obtained a valid and perfected security interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions II.C.1 through II.C.6 above, as applicable, will the FCM or the 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 Collateral transferred from time to time when required pursuant to the Covered Agreement?

8. Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the validity and/or perfection of a security interest in the Customer's rights and interests in respect of any type of Collateral (*e.g.*, because the Collateral is Located or deemed Located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected security interest in the Collateral under the laws of such other jurisdiction, will the FCM have a valid security interest in the Collateral so far as the laws of your jurisdiction are concerned? Is any action (filing, registration, notification, stamping or notarization or any other action or the obtaining or any governmental, judicial, regulatory or other order, consent or approval) required under the laws of your jurisdiction to establish, perfect, continue or enforce the security interest? Are there any other requirements of the type referred to in question II.C.6 above?

9. Are there any particular duties, obligations or limitations imposed on the FCM in relation to the care of the Collateral held by it pursuant to the security interest?

10. Do the laws of your jurisdiction recognize the right of the FCM to use cash or securities Collateral (as described in Additional Assumptions II.B.2 and II.B.3 above) pursuant to an agreement with the

Customer? In particular, how does such use of the Collateral affect, if at all, the validity, continuity, perfection or priority of the 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 such Collateral under the laws of your jurisdiction?

Enforcement of the security interest in the Customer's rights and interests in the Collateral in the absence of an insolvency proceeding

Note Additional Assumption II.B.5 above, which applies to questions II.C.11 through II.C.14 below.

11. Assuming that the FCM has obtained a valid and perfected security interest under the laws of your jurisdiction, to the extent such laws apply, by complying with the requirements set forth in your responses to questions II.C.1 through II.C.6 above, as applicable, what are the formalities (including the necessity to obtain a court order or conduct an auction), notification requirements (to the Customer or any other person) or other procedures, if any, that the FCM must observe or undertake in enforcing its security interest as a secured party under the Covered Agreement? For example, is it free to sell the Collateral (including to itself) and apply the proceeds to satisfy the Customer's outstanding obligations under the Covered Agreement? Do such formalities or procedures differ depending on the type of Collateral involved?

12. Assuming that (a) pursuant to the laws of your jurisdiction, the laws of another jurisdiction govern the validity and/or perfection of a security interest in the Customer's rights and interests in respect of any Collateral (*e.g.*, because such Collateral is Located or deemed Located outside your jurisdiction) and (b) the FCM has obtained a valid and perfected security interests under the laws of such other jurisdiction, are there any formalities, notification requirements or other procedures, if any, that the FCM must observe or undertake in your jurisdiction in exercising its rights as a secured party under the Covered Agreement?

13. Are there any laws or regulations in your jurisdiction that would limit or distinguish a creditor's enforcement rights with respect to the security interest in the Customer's rights and interests in respect of any type of 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 the security interest?

14. How would your response to questions II.C.11 through II.C.13 above change, if at all, assuming that an insolvency proceeding above 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 Customer (for example, would this affect this ability of the FCM to enforce its security interest in the Customer's rights and interests in the Collateral)?

Enforcement of the security interest in the Customer's rights and interests in Collateral after the commencement of an insolvency proceeding

Note Additional Assumption II.B.6 above, which applies to questions II.C.15 through II.C.17 below.

15. How are competing priorities between creditors determined in your jurisdiction? What conditions must be satisfied if the FCM's security interest in the Customer's rights and interests in each type of Collateral is to have priority over all other claims (secured or unsecured) of an interest in the Collateral?

16. Would the FCM's enforcement of its security interest in the Customer's rights and interests in any type of Collateral be subject to any stay, moratorium or freeze or otherwise be affected by commencement of the insolvency?

17. Will the Customer (or its administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official) be able to recover any transfers of 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 a transfer constituting a "preference," fraudulent transfer or transaction at an undervalue (however called and whether or not fraudulent) in favor of the FCM or on any other basis? If so, how long before the insolvency does this suspect period begin? Would the posting of additional margin (which could be required when the Customer Account's net liquidating equity has fallen below the required margin level for the Customer Account due to trading losses in respect of one or more Covered Contracts cleared for the Customer) during the suspect period be subject to avoidance, either because the Collateral was considered to relate to an antecedent or pre-existing obligation or for some other reason?

Miscellaneous

18. If relevant in your jurisdiction, please analyze whether or not the Covered Agreement, and the collateral arrangements contemplated thereby, would constitute a financial collateral arrangement under the local implementation of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

19. Are there any other local law considerations that you would recommend the FCM to consider in connection with enforcing its security interest in the Customer's rights and interests in respect of any Collateral?

20. Are there any other circumstances you can foresee that might affect the FCM's ability to enforce its security interest in the Customer's rights and interests in respect of Collateral in your jurisdiction?

Very truly yours,

[INSERT NAME]

APPENDIX A
SEPTEMBER 2009

CUSTOMER TYPES[3]

Description	**Covered by opinion**	**Legal form(s)**[4]
Bank/Credit Institution. A legal entity, which may be organized as a corporation, partnership or in some other form, that conducts commercial banking activities, that is, whose core business typically involves (a) taking deposits from private individuals and/or corporate entities and (b) making loans to private individual and/or corporate borrowers. This type of entity is sometimes referred to as a "commercial bank" or, if its business also includes investment banking and trading activities, a "universal bank". (If the entity only conducts investment banking and trading activities, then it falls within the "Investment Firm/Broker Dealer" category below.) This type of entity is referred to as a "credit institution" in European Community (**EC**) legislation. This category may include specialised types of bank, such as a mortgage savings bank (provided that the relevant entity accepts deposits and makes loans), or such an entity may be considered in the local jurisdiction to constitute a separate category of legal entity (as in the case of a building society in the United Kingdom (**UK**)).	[Yes][No]	
Central Bank. A legal entity that performs the function of a central bank for a Sovereign or for an area of monetary union (as in the case of the European Central Bank in respect of the euro zone).		
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		

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

[4] If appropriate, please indicate, as discussed in the instruction letter, any naming convention or rule that would help a reader of the opinion to identify and classify the entity.

Description	Covered by opinion	Legal form(s)[4]
does not fall within one of the other categories in this Appendix B.		
Hedge Fund/Proprietary Trader. A legal entity, which may be organized as a corporation, partnership or in some other legal form, the principal business of which is to deal in and/or manage securities and/or other financial instruments and/or otherwise to carry on an investment business predominantly or exclusively as principal for its own account.		
Insurance Company. A legal entity, which may be organised as a corporation, partnership or in some other legal form (for example, a friendly society or industrial & provident society in the UK), that is licensed to carry on insurance business, and is typically subject to a special regulatory regime and a special insolvency regime in order to protect the interests of policyholders.		
International Organization. An organization of Sovereigns established by treaty entered into between the Sovereigns, including the International Bank for Reconstruction and Development (the World Bank), regional development banks and similar organizations established by treaty.		

Description	Covered by opinion	Legal form(s)[4]
Investment Firm/Broker Dealer. A legal entity, which may be organized as a corporation, partnership or in some other form, that does not conduct commercial banking activities but deals in and/or manages securities and/or other financial instruments as an agent for third parties. It may also conduct such activities as principal (but if it does so exclusively as principal, then it most likely falls within the "Hedge Fund/Proprietary Trader" category above.) Its business normally includes holding securities and/or other financial instruments for third parties and operating related cash accounts. This type of entity is referred to as a "broker-dealer" in US legislation and as an "investment firm" in EC legislation.		
Investment Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide investors with a share in profits or income arising from property acquired, held, managed or disposed of by the manager(s) of the legal entity or arrangement or a right to payment determined by reference to such profits or income. This type of entity or arrangement is referred to as a "collective investment scheme" in EC legislation. It may be regulated or unregulated. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by general law and/or, typically in the case of regulated Investment Funds, financial services legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Investment Fund (for example, a trustee of a unit trust) contract on behalf of the Investment Fund, are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement.		

Description	Covered by opinion	Legal form(s)[4]
Local Authority. A legal entity established to administer the functions of local government in a particular region within a Sovereign or State of a Federal Sovereign, for example, a city, county, borough or similar area.		
Partnership. A legal entity or form of arrangement without legal personality that is (a) organised as a general, limited or some other form of partnership and (b) does not fall within one of the other categories in this Appendix B. If it does not have legal personality, it may nonetheless be treated as though it were a legal person for certain purposes (for example, for insolvency purposes) and not for other purposes (for example, tax or personal liability).		
Pension Fund. A legal entity or an arrangement without legal personality (for example, a common law trust) established to provide pension benefits to a specific class of beneficiaries, normally sponsored by an employer or group of employers. It is typically administered by one or more persons (who may be private individuals and/or corporate entities) who have various rights and obligations governed by pensions legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Pension Fund (for example, a trustee of a pension scheme in the form of a common law trust) contract on behalf of the Pension Fund and are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement.		
Sovereign. A sovereign nation state recognized internationally as such, typically acting through a direct agency or instrumentality of the central government without separate legal personality, for example, the ministry of finance, treasury or national debt office. This category does not include a State of a Federal Sovereign or other political sub-division of a sovereign nation state if the sub-division has separate legal personality (for example, a Local Authority) and it does not include any		

Description	Covered by opinion	Legal form(s)[4]
legal entity owned by a sovereign nation state (see "Sovereign-owned Entity").		
Sovereign Wealth Fund. A legal entity, often created by a special statute and normally wholly owned by a Sovereign, established to manage assets of or on behalf of the Sovereign, which may or may not hold those assets in its own name. Such an entity is often referred to as an "investment authority". For certain Sovereigns, this function is performed by the Central Bank, however for purposes of this Appendix B the term "Sovereign Wealth Fund" excludes a Central Bank.		
Sovereign-Owned Entity. A legal entity wholly or majority-owned by a Sovereign, other than a Central Bank, or by a State of a Federal Sovereign, which may or may not benefit from any immunity enjoyed by the Sovereign or State of a Federal Sovereign from legal proceedings or execution against its assets. This category may include entities active entirely in the private sector without any specific public duties or public sector mission as well as statutory bodies with public duties (for example, a statutory body charged with regulatory responsibility over a sector of the domestic economy). This category does not include local governmental authorities (see "Local Authority").		
State of a Federal Sovereign. The principal political sub-division of a federal Sovereign, such as Australia (for example, Queensland), Canada (for example, Ontario), Germany (for example, Nordrhein-Westfalen) or the United States of America (for example, Pennsylvania). This category does not include a Local Authority.		

**CERTAIN TRANSACTIONS UNDER
THE ISDA MASTER AGREEMENTS**

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

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

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

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

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

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

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

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

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

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

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price, and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. A Commodity Forward may be settled by the physical delivery of the commodity in exchange for the specified price or may be cash settled based on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index based on the price of one or more commodities.

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

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

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

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

Credit Default Swap. A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity") upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. A

Credit Default Swap may also be physically settled by payment of a specified fixed amount by one party against delivery of specified obligations ("Deliverable Obligations") by the other party. A Credit Default Swap may also refer to a "basket" (typically ten or less) or a "portfolio" (eleven or more) of Reference Entities or may be an index transaction consisting of a series of component Credit Default Swaps.

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

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

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

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

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

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

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

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity and shares to be set on a

specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

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

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

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

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

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

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

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

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

redemption value (in the case of a put) as measured on the valuation date or dates relating to the exercise date).

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

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

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

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

Longevity/Mortality Transaction. (a) A transaction employing a derivative instrument, such as a forward, a swap or an option, that is valued according to expected variation in a reference index of observed demographic trends, as exhibited by a specified population, relating to aging, morbidity, and mortality/longevity, or (b) A transaction that references the payment profile underlying a specific portfolio of longevity- or mortality- contingent obligations, e.g. a pool of pension liabilities or life insurance policies (either the actual claims payments or a synthetic basket referencing the profile of claims payments).

Non-deliverable Digital Asset Forward. A transaction in which one party agrees to pay the other party an amount of a given currency to be determined on a specified date in the future, where the amount payable, and the party required to pay it, is determined by the amount by which the prevailing market price of a Reference Digital Asset at the time of settlement either exceeds or is less than a specified forward price, as applied to a specified notional quantity of the Reference Digital Asset. For the purposes of this definition, “Reference Digital Asset” means either Bitcoin or Ether.

Non-deliverable Digital Asset Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment in an amount of a given currency equal to the amount by which the price of the Reference Digital Asset either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike price. For the purposes of this definition, “Reference Digital Asset” means either Bitcoin or Ether.

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

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

Renewable Energy Certificate Transaction. A transaction in which one party agrees to buy from or sell to the other party a specified quantity of renewable energy certificates, renewable energy credits or other analogous products (each, a "Renewable Energy Certificate" or "REC"), at a specified price for settlement either on a "spot" basis or on a specified future date and is settled by physical delivery, transfer, export, retirement, cancellation, redemption or other analogous utilization of RECs in exchange for a specified price.

A REC Transaction may also be structured as an option for which a quantity of RECs is settled in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay the difference between the market price of that quantity of RECs on the exercise date and the strike price.

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

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

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

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

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

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

Variance Swap. A transaction in which one party (the "Seller") pays the other party (the "Buyer") a cash settlement amount, if positive, or the Buyer pays the Seller the absolute value of that cash settlement amount, if negative. The cash settlement amount is based on the difference between the realized variance of the underlying asset over a specified period and a fixed implied variance level.

VCC Transaction. A transaction in which one party agrees to buy from, or sell to, the other party a specified quantity of verified carbon credits each with a unique serial number, measured in tCO2e,

representing an emission reduction and quantified, verified and issued into a registry account ("VCCs") at a specified price for settlement either on a "spot" basis or on a specified future date. A VCC Transaction may also be structured as an option whereby one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantify of VCCs at a specified strike price. A VCC Transaction can be settled by physically delivering or retiring VCCs in exchange for a specified price or specified strike price.

Volatility Swap. A transaction in which one party (the "Seller") pays the other party (the "Buyer") a cash settlement amount, if positive, or the Buyer pays the Seller the absolute value of that cash settlement amount, if negative. The cash settlement amount is based on the difference between the realized volatility of the underlying asset over a specified period and a fixed implied volatility level.

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

CERTAIN COUNTERPARTY TYPES[1]

Description	Covered by opinion[2]	Legal form(s)[3]
Bank/Credit Institution. A legal entity, which may be organized as a corporation, partnership or in some other form, that conducts commercial banking activities, that is, whose core business typically involves (a) taking deposits from private individuals and/or corporate entities and (b) making loans to private individual and/or corporate borrowers. This type of entity is sometimes referred to as a "commercial bank" or, if its business also includes investment banking and trading activities, a "universal bank". (If the entity only conducts investment banking and trading activities, then it falls within the "Investment Firm/Broker Dealer" category below.) This type of entity is referred to as a "credit institution" in European Community (**EC**) legislation. This category may include specialised types of bank, such as a mortgage savings bank (provided that the relevant entity accepts deposits and makes loans), or such an entity may be considered in the local jurisdiction to constitute a separate category of legal entity (as in the case of a building society in the United Kingdom (**UK**)).	Yes	HKSAR Company[4]
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).	No	

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

2 This column indicates whether an entity of the relevant type falls within the scope of this memorandum. Where the answer is "No", this is due to the fact that to include this type of entity would require substantial additional legal analysis, beyond the scope of our current instructions.

3 This column indicates the legal form in which an entity of the relevant type is typically organised in the HKSAR under HKSAR law. While it is possible, in some cases, that an entity falling within the commercial description in the left-hand column could be organised in a different legal form in the HKSAR, any such entity would not fall within the scope of this memorandum, unless expressly provided to the contrary. For example, an Investment Firm organised as a limited liability partnership is not within the scope of this memorandum. A capitalised term used in this column has, unless context indicates otherwise, the meaning given to that term of this memorandum.

4 There are various forms of HKSAR company, namely a company limited by shares, an unlimited company with share capital, a company limited by guarantee and an unlimited company without share capital. Further, each of such companies may be a private company or a non-private company. The naming convention for HKSAR companies limited by shares or guarantee is set out in section 5 of the CO. If the name of the company is in English, a limited liability company must have the word 'Limited' as part of its name and/or, if the name of the company is in Chinese, must have the Chinese equivalent. An unlimited company either with or without share capital is not required to have any specific word or abbreviation at the end of its name.

Description	Covered by opinion[2]	Legal form(s)[3]
Corporation. A legal entity that is organized as a corporation or company rather than a partnership, is engaged in industrial and/or commercial activities and does not fall within one of the other categories in this Appendix B.	Yes	HKSAR Company
Hedge Fund/Proprietary Trader. A legal entity, which may be organized as a corporation, partnership or in some other legal form, the principal business of which is to deal in and/or manage securities and/or other financial instruments and/or otherwise to carry on an investment business predominantly or exclusively as principal for its own account.	Yes	HKSAR Company
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.	No	
International Organization. An organization of Sovereigns established by treaty entered into between the Sovereigns, including the International Bank for Reconstruction and Development (the World Bank), regional development banks and similar organizations established by treaty.	No	
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.	Yes	HKSAR Company
Investment Fund. A legal entity or an arrangement without legal personality (for example, a common	No	

Description	Covered by opinion[2]	Legal form(s)[3]
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.	No	
Partnership. A legal entity or form of arrangement without legal personality that is (a) organised as a general, limited or some other form of partnership and (b) does not fall within one of the other categories in this Appendix B. If it does not have legal personality, it may nonetheless be treated as though it were a legal person for certain purposes (for example, for insolvency purposes) and not for other purposes (for example, tax or personal liability).	No	
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	No	

Description	Covered by opinion[2]	Legal form(s)[3]
governed by pensions legislation. Where the arrangement does not have separate legal personality, one or more representatives of the Pension Fund (for example, a trustee of a pension scheme in the form of a common law trust) contract on behalf of the Pension Fund and are owed the rights and owe the obligations provided for in the contract and are entitled to be indemnified out of the assets comprised in the arrangement.		
Sovereign. A sovereign nation state recognized internationally as such, typically acting through a direct agency or instrumentality of the central government without separate legal personality, for example, the ministry of finance, treasury or national debt office. This category does not include a State of a Federal Sovereign or other political sub-division of a sovereign nation state if the sub-division has separate legal personality (for example, a Local Authority) and it does not include any legal entity owned by a sovereign nation state (see "Sovereign-owned Entity").	No	
Sovereign Wealth Fund. A legal entity, often created by a special statute and normally wholly owned by a Sovereign, established to manage assets of or on behalf of the Sovereign, which may or may not hold those assets in its own name. Such an entity is often referred to as an "investment authority". For certain Sovereigns, this function is performed by the Central Bank, however for purposes of this Appendix B the term "Sovereign Wealth Fund" excludes a Central Bank.	No	
Sovereign-Owned Entity. A legal entity wholly or majority-owned by a Sovereign, other than a Central Bank, or by a State of a Federal Sovereign, which may or may not benefit from any immunity enjoyed by the Sovereign or State of a Federal Sovereign from legal proceedings or execution against its assets. This category may include entities active entirely in the private sector without any specific public duties or public sector mission as well as statutory bodies with public duties (for example, a statutory body charged with regulatory responsibility over a sector of the domestic	No	

Description	Covered by opinion[2]	Legal form(s)[3]
economy). This category does not include local governmental authorities (see “Local Authority”).		
State of a Federal Sovereign. The principal political sub-division of a federal Sovereign, such as Australia (for example, Queensland), Canada (for example, Ontario), Germany (for example, Nordrhein-Westfalen) or the United States of America (for example, Pennsylvania). This category does not include a Local Authority.	No	