July 13, 2009

REPORT TO THE SUPERVISORS OF THE MAJOR OTC DERIVATIVES DEALERS ON THE PROPOSALS OF CENTRALIZED CDS CLEARING SOLUTIONS FOR THE SEGREGATION AND PORTABILITY OF CUSTOMER CDS POSITIONS AND RELATED MARGIN

This Report to the Supervisors of the Major OTC Derivatives Dealers[1] (the "Report") has been prepared by an ad hoc group comprising both buy-side and sell-side constituents ("we" or the "Group")[2] to explore the rights of "customers"—e.g., buy-side and other market participants proposing to clear CDS through clearing members ("CMs") of a central CDS counterparty ("CCP")[3]—in regard to the segregation and portability of CDS positions and associated initial margin ("margin"). To this end, we solicited responses from CME Clearing and ICE Trust U.S. LLC (collectively, the "U.S. CCPs") and Eurex

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1 Such supervisors consist of the Board of Governors of the Federal Reserve System, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Secrétariat Général de la Commission Bancaire, German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority and United Kingdom Financial Services Authority.

2 The Group was formed at the behest of the Federal Reserve Bank of New York, and consists of buy-side members AllianceBernstein, Barclays Global Investors, BlueMountain Capital Management LLC, Brevan Howard, D. E. Shaw Group, Goldman Sachs Asset Management, King Street Capital Management, L.P. and PIMCO, and sell-side members Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, The Goldman Sachs Group, Inc., J.P. Morgan, Morgan Stanley and UBS. The International Swaps and Derivatives Association (ISDA), the Asset Managers Group of SIFMA, and Managed Funds Association (collectively, the "Trade Associations") are facilitating and observing the Group's activities. Cleary Gottlieb Steen & Hamilton LLP acted as legal counsel to the Group and Lenz & Staehelin advised on Swiss law matters. For questions or further information about this Report, please contact the Trade Associations.

This Report is part of ongoing industry efforts to enable customer access to CDS clearing solutions, an initiative described in the letter delivered to the Federal Reserve Bank of New York on June 2, 2009 from certain sell-side and buy-side institutions:

> It is our goal to achieve buy-side access to CDS clearing (through either direct CCP membership or customer clearing) with customer initial margin segregation and portability of customer transactions no later than December 15, 2009. The legal and regulatory analysis to achieve buy-side access will be completed and delivered to supervisors by June 30, 2009. A joint buy- and sell-side group coordinated through IBOC initiated the analysis. If through the analysis we confirm or determine that regulatory and/or legislative changes are required to accomplish buy-side access to CDS clearing with customer initial margin segregation and portability of customer transactions, we will seek assistance from supervisors. In connection with the foregoing, strategic commercial review will be performed by individual institutions which will consider, among other things, tax, legal, regulatory, risk management, interoperability among existing CCPs, implementation, and ongoing operational costs, capital, margining and compliance implications. Subject to the strategic commercial review, dealers who provide customer clearing services in the ordinary course of their businesses, agree to provide clearing services through CCPs that have (i) broad buy-side and dealer support and (ii) a commitment to develop viable direct and indirect buy-side clearing models. In addition, the market needs to accomplish several work streams including the roll out of Restructuring Credit Event Protocol (small bang) and of single name and index clearing for the U.S./Europe and build out of operational infrastructures industry-wide.

3 This Report does not discuss "self-clearing" market participants—i.e., buy-side and other participants in the CDS market that themselves become CMs in one or more of the CCPs. Participants which satisfy a CCP's requirements for CMs and choose to become self-clearing will not have the issues discussed in this Report, although they may be subject to a different set of exposures to the CCP and the other CMs (e.g., provisions for mutualization of losses among CMs, guarantee fund contributions and contingent assessment powers by the CCP).

Clearing AG, ICE Clear Europe, LCH.Clearnet Limited/NYSE Liffe and LCH.Clearnet SA (collectively, the "European CCPs") on various matters relating to the protection of customer positions and related margin in the event of a CM default.[4] This Report is not an exhaustive analysis of all potential legal issues.[5] In addition, there are a host of business, operational and other legal considerations relevant to the determination of which clearing structure is optimal for any particular CM or customer.[6]

Many of the issues discussed below would only arise in a "worst-case" scenario of a liquidation of the CM and no transfer of customer positions and related margin to a successor. There is reason to believe that the failure of a CM might result in an orderly transfer of customer positions and related margin to another financial institution. For instance, the failure of any U.S. bank insured by the Federal Deposit Insurance Corporation ("FDIC") or U.S. futures commission merchant ("FCM") might well result in an orderly transfer of CDS positions (and related margin) to another financial institution or FCM.[7] However, recent historical experience (e.g., the administration of Lehman Brothers International (Europe) ("LBIE")) suggests the need to understand in greater detail the consequences of a "worst-case" scenario on customer rights to positions and related margin at a failed intermediary.

In the event customer positions and margin are not transferred, even if customer margin is adequately segregated, a potential challenge for a customer of an insolvent CM is the practical difficulty of obtaining the timely return to it of assets to which it is entitled as a matter of law, but which (as a matter of practice) may not be released to the customer in a timely manner.[8] These concerns would be

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4 The Group has engaged the CCPs in a process involving written questionnaires, responses and meetings throughout late May and June 2009. The Group has prepared a preliminary, detailed working paper that is being discussed with regulators and CCPs on a CCP-by-CCP basis.

5 Expressly excluded from the scope of the Report are, among other matters, issues relating to: (i) the governance structure of the CCPs, (ii) the calculation of required margin amounts, (iii) variation margin (or mark-to-market margin), (iv) the creditworthiness of the CCPs and the adequacy of margin and other funding arrangements, (v) the creditworthiness of the CMs and other matters affecting the likelihood, rather than the consequences, of a CM default, (vi) restrictions on setoff of cleared positions against non-cleared positions and (vii) the consequences of expanding or restricting the range of permitted CM and customer entity types and jurisdictions. Other examples of matters excluded from the scope of this Report are analyses of (a) the consequences of the CCP's insolvency or the insolvency of a third-party custodian at which the margin is held, and (b) the rights of the CCP and CM against customers in the event of a customer's insolvency. This Report does not address the risk of fraud, and assumes that the relevant CM has complied with its segregation and other obligations in respect of customer margin.

6 Individual CCPs, CMs and customers should also consult with counsel on the matters discussed in this Report. No person or entity should rely upon this Report as definitive legal advice.

7 To our knowledge, in every case in which a large U.S. bank has become the subject of an FDIC receivership proceeding, all qualified financial contracts (e.g., CDS positions) and associated margin of the failed bank were transferred in their entirety to a single bridge bank or third-party acquiror. Customers would therefore continue to deal with the acquiror, with little or no systemic disruption. And with respect to FCMs, recent history suggests that bulk transfers of customer positions and margin from a failing FCM are likely to occur. For example, in the case of Lehman Brothers Inc. (an FCM), customers were able to transfer their positions and associated margin to other FCMs, even after the parent company (Lehman Brothers Holdings Inc.) had filed for bankruptcy. Customer accounts and associated margin remaining when Lehman Brothers Inc. entered liquidation were transferred in bulk to Barclays Capital Inc. (also an FCM). The transfers were generally conducted in an expedited fashion without any material issues.

8 In the case of LBIE, margin securing futures and options traded on non-U.S. exchanges was promptly released by the exchanges to LBIE's administrators. As of the date of this Report, such margin generally has not been released by LBIE's administrators. The administrators have stated that this delay has arisen due to the complexities of the case, and in particular, because margin was commingled with client funds associated with other activities of LBIE (such as stock lending and OTC trading) and also because a large number of LBIE clients

largely resolved if customer margin could be returned directly to a defaulting CM's customers and not to its insolvency representative, or if a legal regime could be instituted that would provide for a mechanism for the prompt return of customer margin (even if held in omnibus accounts). However, it is not possible to have a customer protection regime that ensures prompt return of customer margin while also providing for the holding of such margin in omnibus customer accounts. If margin is held at or through an insolvent CM, the insolvency representative of the CM may not release the margin until all custodial claims have been processed and the entitlements of various claimants have been fully resolved. (We refer in this Report to liquidators, administrators, trustees, receivers, conservators, debtors-in-possession and the like as "insolvency representatives".) In addition, consideration would have to be given to how customer liabilities to the CM are satisfied prior to the return of margin to the customer. Even if margin is held away from the insolvent CM, absent a contractual relationship directly between customers of the CM and the CCP or third-party custodian (as applicable), the CCP or third-party custodian would almost certainly return the margin to the CM's insolvency representative, rather than directly to the customers. Certain regimes, such as those applicable to U.S. FDIC-insured banks and U.S. FCMs, provide mechanisms that, although they do not ensure prompt return, promote such a result.

The U.S. CCPs and European CCPs have various mechanisms for the protection of customer positions and related margin, and differ in several key respects. As an initial matter, certain CCPs permit a variety of CM organizational types and jurisdictions, while others are more restricted. The range of permitted CM organizational types and jurisdictions—as well as where and in which manner customer margin is held—critically affects which laws may be applicable to customers seeking the return of their margin through the insolvent CM. With respect to the segregation of margin, certain CCPs have pledge arrangements, others have title transfer arrangements and yet others have title transfer combined with trust or security interest arrangements. In addition, certain CCPs provide for customer margin to be pledged (or repledged) to the CCP, while others allow only CM proprietary margin to be pledged to the CCP (with customer margin segregated—or not—at the CM). All but one of the CCPs provides for omnibus accounts, rather than accounts in a particular customer's name. Many of the details of some of these arrangements are still under development (with some of the proposals much further ahead than others), while some of the arrangements largely rely on pre-existing clearing models.

For all of the proposals that are beyond the early development stage (as to which it is difficult to evaluate), we believe that such proposals represent significant improvements over the current OTC CDS market in protecting customer margin and enhancing portability. That being said, no proposal is perfect in its current form, especially given the imperfect or unclear state of relevant law. All of the proposals could benefit—to a greater or lesser degree, depending on the structure of the CCP's clearing solution and the laws applicable to the CCP and the CMs—from legislative or regulatory changes to enhance the customer protection analysis.

This Report discusses, in general terms, considerations relevant to an analysis of the customer protection frameworks of the various CCPs, and then outlines legislative and regulatory proposals that may be helpful in enhancing the protection of customer positions and related margin in the event of a CM default.

I. Customer Protection Issues Generally

In the event of a CM default, the two essential elements of the customer protection analysis are (i) the manner in which margin is provided and held, and particularly, the extent to which margin is

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consented to having their money held outside of segregation. As LBIE's administrators are required to treat all creditors equally and to avoid returning any assets until they have ascertained each claimant's exact position, they have yet to release such margin.

segregated from the CM's assets and recoverable by the customers (the "Segregation Analysis") and (ii) the effectiveness of the CCP's procedures for the transfer or novation of customer positions and related margin (the "Portability Analysis").

Both the Segregation Analysis and the Portability Analysis depend in large part upon the law applicable to the defaulting CM, which in turn varies by the entity type and jurisdiction of the CM. This Report considers the following entity types: U.S. banks, U.S. FCMs, U.S. federal and New York branches of non-U.S. banks, U.S. unregulated entities, English FSA-regulated entities, French financial institutions, German financial institutions and Swiss financial institutions, and English branches of French, German and Swiss banks.

A. Segregation Analysis

Inquiry into the manner in which margin is provided and held is important because it affects (i) the likelihood that positions and related margin will be successfully transferred in the event of a CM default and (ii) a customer's ability to ultimately recover its margin in the event its positions and related margin cannot be transferred.

Security Interest and Trust Arrangements vs. Title Transfer Arrangements

The manner by which customers post margin (e.g., security interest or title transfer) may have important effects on the customer protection analysis. If customers were to grant a security interest in their margin, as collateral for their outstanding cleared CDS, the margin would remain property of the customers, subject to the rights of the secured parties. Once any obligations secured by the pledged margin have been discharged, the secured parties generally would maintain no further interest in the margin.

If, on the other hand, customers were to post margin under a title transfer arrangement, they would forfeit their proprietary interests in such margin immediately upon such transfer. Even after any obligations "secured" by the transferred margin have been discharged, the customers in this case would retain only a contractual claim against the transferees for the return of the margin so transferred, not a proprietary interest therein. Notwithstanding the foregoing, where customers have transferred title to their margin, it may nevertheless be possible for CMs to establish trust or security interest arrangements that would allow customers to establish proprietary interests in the margin or in the contractual obligation of the holder of margin to return such margin to the CM (as agent or custodian for the customers). These arrangements may be helpful in the event of the CM's insolvency, as it might allow customers to recover any such margin that is returned to the insolvent CM ahead of the claims of unsecured creditors.

The distinction between proprietary and contractual claims may be critical in the event of a CM insolvency. Contractual claimants are generally afforded the status of mere unsecured creditors in an insolvency proceeding. Proprietary claimants, on the other hand, may have the ability (subject to tracing or other requirements) to recover their property ahead of unsecured creditors, on the ground that the property they deposited with the insolvent entity did not form part of the insolvency estate, but was merely held in a safekeeping or custodial capacity.[9]

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[9] As discussed above, we do not principally focus on timing issues in this Report—e.g., when customers will be able to recover their margin. Although we note certain instances in which timing concerns may be particularly relevant, our primary focus is on whether customers will be able to recover their margin. This is because timing issues are inherently unpredictable, and depend upon the complexities of each case.

To the extent CMs and customers decide to change to a security interest arrangement from an existing title transfer arrangement for the posting of margin, the parties should be mindful of any legal, operational, commercial or other issues that may arise in the course of such a transition—in particular, the rights of CMs against the customer upon a customer default or insolvency, and any filing or other requirements to perfect the security interest.

CCP's Collection of Gross vs. Net Margin

CCPs can collect margin from CMs either on a gross basis (i.e., the CCP collects from each CM all margin amounts posted by such CM's customers on account of CCP-imposed margin requirements (the "Gross Amount")) or on a net basis (i.e., the CCP collects from each CM a level of margin sufficient to account for the aggregate risk to the CCP of such CM's customer positions (the "Net Amount"), with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement).

Collection by CCPs of gross margin may enhance both the Segregation Analysis and the Portability Analysis. If CCPs collect customer margin from CMs on a net basis, then it is important from a portability standpoint that the excess of the Gross Amount over the Net Amount (the "Excess Amount") be effectively segregated and accessible by the CCP, for transferability (rather than loss mutualization) purposes—ideally without the consent or cooperation of the CM's insolvency representative—upon a CM insolvency. To the extent the Excess Amount remains at the CM at the time of its insolvency, the CCP may only have the ability to transfer the Net Amount, unless the CCP has the cooperation of the CM's insolvency representative (which it may be able to obtain so long as the Excess Amount is segregated from the assets of the CM). If the CCP can only transfer the Net Amount, the associated customer positions are more likely to be undermargined at the transferee CM. Since no CM is likely to willingly accept the transfer of significantly undermargined customer positions (unless the transferee CM is satisfied that the customers will remedy the margin shortfall upon any transfer), collection by the CCP of only the Net Amount may have adverse effects upon portability, absent a separate requirement imposed upon CMs to segregate the Excess Amount in an account that the CCP can access in the event of a CM's insolvency.

Securities vs. Cash

The type of property posted as margin may also affect the customer protection analysis. As securities and cash are the most common forms of margin, we discuss them briefly here.

For certain entity types, whether margin is posted in the form of securities or cash is irrelevant (as a legal matter) to the customer protection analysis. For example, so long as a customer has a "net equity" claim under the U.S. Bankruptcy Code in an FCM's insolvency proceeding, it is irrelevant whether the net equity claim derives from cash or securities posted by the customer. However, for other entity types (generally speaking), the posting of securities is preferable to cash from a customer protection standpoint. For example, under New York law, if margin consisting of securities has been credited to a "securities account" in the name of the customer by a "securities intermediary", in each case within the meaning of Article 8 of the Uniform Commercial Code, as enacted in the State of New York (the "UCC"), then the customer would retain a proprietary interest in such securities, on a pro rata, CUSIP-by-CUSIP basis with other proprietary claimants of the intermediary that have such securities credited to their securities accounts. Under English law, whether customers can demonstrate a proprietary interest in margin consisting of securities largely depends upon the extent to which (i) the securities are adequately segregated from the assets of the insolvent secured party, (ii) the rights relating to such securities remain free of liens and the securities are not subject to rehypothecation and (iii) the books and records of the insolvent secured party demonstrate the customer's ownership rights.

Compared to securities, cash is relatively more fungible. Therefore, it is generally more difficult or sometimes not possible for a claimant to demonstrate a proprietary interest in margin consisting of cash. However, in certain instances, applicable law may provide customers with the possibility of demonstrating proprietary rights in cash. For example, under New York law, it may be possible for a customer to establish proprietary rights in cash that has been credited to a securities account in the customer's name by a securities intermediary.[10] And under English law, it may be possible that the cash is held subject to an express trust or would be classified as "client money" under the Client Asset Sourcebook rules, subject to a statutory trust in favor of the customer as beneficial owner. However, under the laws of certain other jurisdictions (e.g., France, Germany and Switzerland), customers holding cash at the secured party do not maintain, in principle, proprietary interests in such cash, since it is assumed that any such cash was commingled with the estate of the insolvent secured party (unless a specific regime providing for customer protection on cash margin applies). In these jurisdictions, the cash, generally, must be held away from the secured party in order for customers to possibly demonstrate proprietary interests in such cash.

With respect to both securities and cash, the analysis of whether customers maintain proprietary or contractual rights largely depends upon the manner in which the margin is held. We now discuss several considerations that may be relevant in this regard.

Where is the margin held?

Margin may be held at a customer's CM, at the CCP or at a third-party custodian (which may be an affiliate of the CM). In certain cases, CMs may be required under applicable law or regulation to hold customer margin separately from their proprietary assets. In the context of a CM insolvency, customers might well benefit from a structure in which margin is held away from the CMs, either at the CCP or at a third-party custodian (assuming the CCP or the third-party custodian is not itself insolvent).[11] Holding margin away from an insolvent CM may be helpful to customers for several reasons: (i) it enhances customers' ability to trace the margin; (ii) it supports the notion that ownership of the margin did not pass to the insolvent CM's estate (particularly helpful in the case of cash); and (iii) it may mitigate the timing burdens associated with the customers' recovery of margin.

If margin is held at multiple entities, the Segregation Analysis should be conducted at each relevant entity. For instance, CCPs may distinguish between (i) margin posted in respect of CCP-imposed requirements and (ii) any margin posted by customers in excess of such requirements.

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[10] Under limited circumstances, cash not credited to a securities account may be treated as a "special deposit" entitled to custodial treatment under New York law. However, to the extent any cash held in custody is commingled with other deposits at an upper-tier intermediary (e.g., the Federal Reserve Bank of New York) through which it is held, or subject to any liens at an upper-tier intermediary, it is uncertain what the customer's rights to such cash would ultimately be (even if, as between the customer and the CM, such cash could qualify as a "special deposit").

[11] Judgment as to which of these alternatives is optimal from a customer protection standpoint depends in the first instance upon the allocation of insolvency risk. If margin is held at the CCP or at a third-party custodian, and the CM bears the risk of loss upon the insolvency of the CCP or the third-party custodian, holding away from the CM would clearly enhance customer rights. (We note in this regard that the standard New York law Credit Support Annex and English law Credit Support Deed to the ISDA Master Agreement allocates the risk of a custodian's insolvency to the secured party. However, the parties are free to vary this default risk allocation by agreement.) On the other hand, to the extent the customers are responsible for such insolvency risk, judgment as to where the margin should be held is contingent upon a balancing of credit risk, custodial risk, operational risk and other considerations (e.g., additional costs arising from holding at a third-party custodian) for each entity, as customers would effectively be substituting one risk profile for another. This judgment may be affected by whether the third-party custodian is affiliated with the CM, given the possibly heightened risk of a joint insolvency in such a scenario.

Specifically, CCPs may require the former category of margin to be posted to the CCP (or into an account to which the CCP has access), but allow the latter category of margin to be held elsewhere. Even if margin will ultimately be held at a single entity, customers should consider where the margin is to be held until it is transferred, and who bears any risk of loss throughout this intervening period.

Is margin commingled with other assets?

Where margin is held at the CM, the extent to which it is commingled with other assets in the same account may be relevant to the Segregation Analysis. If the CM holds margin together with its proprietary assets or is able to use the margin, it may be more difficult for customers to demonstrate that the margin was held in a custodial capacity, given the commingling of margin with the CM's proprietary assets or the CM's free use of such margin in its business. (However, for certain entity types—e.g., U.S. FCMs and U.S. banks acting as UCC Article 8 securities intermediaries—any commingling of margin by the CM with its own property does not affect whether customers have proprietary rights in such margin.) Any such commingling of customer assets with proprietary assets may also affect the class of custodial claimants with whom customers may be required to share in the event of a shortfall in customer property.

If the CM has commingled a particular CDS customer's margin, not with proprietary assets of the CM, but instead with either (i) other CDS customers' margin or (ii) the custodial property of the CM's other custodial claimants (e.g., trust claimants holding property for safekeeping at the CM), such commingling is not likely to affect the analysis of whether CDS customers have proprietary or contractual rights to the margin—i.e., even if margin is commingled with other custodial property, CDS customers should still have rights to such property superior to those of unsecured creditors of the insolvent CM. However, it may affect the class of custodial claimants with whom the CDS customer may be required to share in the event of a shortfall in custodial property.

Where non-cash margin is held at the CCP or a third-party custodian, it is unlikely to be the case that the margin will be commingled with assets proprietary to the CCP or third-party custodian. However, at least under U.S. law, even if margin were commingled at the CCP or third-party custodian level (as will likely be the case for cash margin) with proprietary or other custodial assets of the CCP or third-party custodian, such commingling should not affect the nature of CDS customers' rights vis-à-vis the CM (i.e., whether the customers have a proprietary interest in the assets or only a contractual right against the CM). In addition, the extent of commingling at the CCP or third-party custodian, and the question of on whose behalf the CCP or third-party custodian is holding the margin—e.g., (a) each CM individually, (b) the CMs collectively, (c) each CDS customer individually, (d) CDS customers collectively or (e) custodial claimants (of the depositing CM) collectively—may affect the class of custodial claimants with whom the CDS customers would have to share in the event of a shortfall in custodial property.

What is the relationship between the CCP, the CM, any custodians and the customers?

Where margin is held at the CCP or a third-party custodian, it is generally the case that, the more direct the contractual relationship between customers and the CCP or third-party custodian, the stronger the corresponding Segregation Analysis becomes. For instance, the notion that ownership of customer margin does not pass to the CM would be buttressed to the extent the CM were acting as agent vis-à-vis the CCP on behalf of customers (rather than as principal). In addition, if the CCP or third-party custodian "knows" customers in this regard, it may be more likely that customers will be able to recover margin directly, rather than from the insolvent CM's insolvency representative.

Is the margin subject to any liens or setoff rights?

To the extent the margin is subject to liens and setoff rights in favor of the CM beyond the rights in respect of cleared transactions, the entity holding such margin may not return the margin to the customer in the event of the CM's insolvency, unless it is absolutely clear that the customer owes no further obligations to the CM. To the extent margin is also subject to liens or setoff rights in favor of affiliates of the CM (e.g., under a cross-margining and netting agreement), the customer's ability to recover the margin may be further complicated. In the event of a dispute regarding entitlement to the margin, the entity holding the margin is likely to either (i) return the margin to the CM's insolvency representatives, or (ii) interplead or deposit the margin with a court and petition the court to require all interested parties to litigate the dispute as between themselves.

Aside from these timing considerations, it is possible that the imposition of liens on the margin, or the exercise of setoff rights, by CMs or their affiliates could diminish the pool of available margin and result in a shortfall in custodial property. Where margin is held away from the CM, any imposition of liens on the margin, or the exercise of setoff rights, by the CCP, the third-party custodian or other entities (e.g., potential lenders or liquidity providers to the CCP) may also present risks to customers seeking recovery of their margin. The practical import of any such liens should be evaluated on a case-by-case basis.

Is the margin or other custodial property of the CM subject to rehypothecation or on-transfer?

Any rehypothecation or on-transfer of customer margin to third parties (other than to the CCP) may have an adverse effect on customer rights to recover such margin. For certain entity types—e.g., CMs that are acting as UCC Article 8 securities intermediaries who have credited the margin to securities accounts on behalf of customers—the rights of customers who have allowed rehypothecation or on-transfer may, relative to other customers, be adversely affected by rehypothecation or on-transfer. For instance, with respect to such securities intermediaries, if the CM were to transfer control over the margin to a secured creditor, custodial claimants would only have a proprietary claim to the extent of any excess remaining after the CM's obligations to the secured creditor had been fully discharged.

Even if a particular customer does not permit rehypothecation or on-transfer, the customer may be required to share in any shortfalls arising from the claims of other custodial claimants who allowed rehypothecation or on-transfer. Whether this will be the case depends in part upon the applicable sharing rules for a shortfall in custodial property. It may also depend upon certain operational practices that are relevant to the sharing analysis—e.g., whether a securities intermediary debits financial assets from securities accounts upon any rehypothecation or on-transfer, to eliminate such claimants' proprietary rights in the debited financial assets, thereby minimizing the possibility that any resulting shortfall would be shared by CDS customers who did not allow rehypothecation or on-transfer.

B. Portability Analysis

Portability of positions and related margin is highly desirable, as it reduces the need for position close-outs and resulting transaction costs (e.g., the cost of reestablishing hedged positions, including bid-offer spreads) and mitigates systemic risk concerns that may arise in connection with the sudden insolvency of a financial institution. As any transfer or novation of positions and related margin requires a willing transferee, it is important to consider the various factors that may diminish or enhance the likelihood that a willing transferee can be found.

The Segregation Analysis is critical to the Portability Analysis, as it is difficult to envisage a successful framework for full portability if customer margin cannot be accessed or identified, or if there is a significant degree of undersegregation of customer margin. The presence of the following factors related to the Segregation Analysis could significantly enhance the Portability Analysis: (i) margin being held away from the CMs; (ii) margin not being commingled with the property of the CMs, and if possible, not commingled with the property of other custodial claimants of the CMs; (iii) the existence of a direct contractual relationship between customers and the margin holder; (iv) margin being free from liens and setoff rights (except liens and setoff rights in favor of the CCP and the CMs in respect of customer trades); and (v) margin not being subject to rehypothecation or on-transfer by the CMs (except to the CCP as margin for customer trades).

II. Legislative and Regulatory Reforms

The overview above of the Segregation Analysis and Portability Analysis is based upon current insolvency law. However, it is important to recognize that change is being considered generally, as is evident from recent financial modernization proposals and ongoing global efforts for legislative and regulatory reform in this area. In both the U.S. and Europe, a wide range of legislative reforms could be implemented to enhance the protection of customer margin, and increase the likelihood that such margin will be successfully transferred (in connection with a porting of positions) or returned to customers. The extent of these reforms should be discussed with market participants and regulators in conjunction with consultations on reforms already underway,[12] as the reforms may have some disadvantages, such as reduced business flexibility, higher costs of doing business and, in some cases, increased risks for other market participants or custodial claimants. We believe the following legislative and regulatory reforms may be particularly helpful—to a greater or lesser degree, depending on the structure of the CCP's clearing solution and the laws applicable to the CCP and the CMs:

- Rules clarifying the treatment of CDS margin upon a CM insolvency;

[12] For example, in the U.S., in its White Paper, "Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation," released on March 26, 2009, the U.S. Treasury proposes a resolution authority for systemically significant financial companies that is modeled on the Federal Deposit Insurance Act insolvency provisions for insured depository institutions. Under such a regime, regulators would have the power to, among other things, place a failed financial company into conservatorship or receivership and transfer its "derivatives" to a "bridge" institution.

With respect to the UK, various reports have been prepared in relation to legal reforms in response to the financial crisis, including: (a) "The Turner Review" (18 March 2009)—The FSA's review on the UK and international approaches to the way banks are regulated. The FSA's Discussion Paper 09/2, which accompanies the Turner Review, recommends steps that the international community needs to take to enhance regulatory standards, supervisory approaches and international cooperation and coordination. The FSA's Discussion Paper was published in March 2009; (b) "UK international financial services – the future" (May 2009)—A report to the UK Government from UK-based financial services leaders whose remit was to examine the competitiveness of financial services globally and to develop a framework on which to base policy and initiatives to keep UK financial services competitive; and (c) "Developing effective resolution arrangements for investment banks" (May 2009)—a HM Treasury publication on the UK Government's initial thoughts on the main areas where reform could be considered in relation to insolvency law, regulation and market practice.

Although some uncertainties relating to the rules contained in the FSA's Client Assets Sourcebook (the "CASS Rules"), which govern the treatment of "client money" and "client assets", may be clarified in due course by English court decisions arising out of the LBIE and other administrations, a wider review and revision of the CASS Rules is seen by the Group as a priority. According to the FSA's Handbook Development Newsletter (May 2009), the FSA intends to commence consultation on the review of the CASS Rules (in particular, the distribution rules) in the fourth quarter of 2009.

- Rules reducing the extent to which CDS clearing customers of CMs will have to share in any shortfall in custodial property, including rules (i) relating to the manner of segregation of custodial property, (ii) enabling or enhancing the ability of CMs to rehypothecate customer margin to CCPs without customers losing their proprietary interest in that margin on the CM's insolvency and (iii) protecting customers against the risk of a CM's failure to segregate money and assets;

- Rules enhancing the ability of CCPs to transfer or novate a CM's customer positions with the CCP and related customer margin posted by that CM to the CCP on that CM's default or insolvency and, where necessary, to effect the transfer or novation of the customer's underlying positions with that CM and related customer margin held by that CM to successor CMs;

- Rules relating to the timely access by customers to their margin after the insolvency of a CM.

- Rules concerning the efficacy of trusts (statutory or otherwise) over assets posted by customers in jurisdictions that do normally recognize the efficacy of trusts;

- Rules designating that the default rules and proceedings of a clearing house take precedence over general insolvency proceedings of the insolvent CM, whether or not such clearing house is in the same jurisdiction as the insolvent CM; and

- Legislation empowering regulators to develop relevant rules relating to any or all of the above matters.

III. Concluding Remarks

As noted above, the determination of which clearing structure for CDS is optimal for any particular CM or customer is a complex analysis. This Report discusses only one facet of that analysis—customer protection of margin. In a worst-case scenario, the customer protection analysis will largely depend upon the insolvency law applicable to the defaulting CM. Ultimately, however, there is no substitute for diligence on the part of customers in carefully choosing a CM with which to do business. The creditworthiness of CMs will be a critical consideration under any customer protection framework.