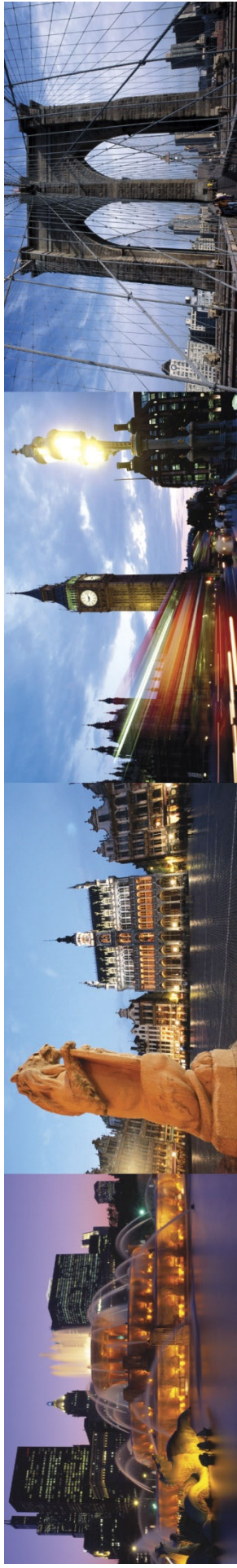




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# LEGAL CHALLENGES IN THE MIDST OF TURMOIL

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"...there are known knowns; there are things we know that we know. There are known unknowns; that is to say, there are things that we now know we don't know. But there are also unknown unknowns – there are things we do not know we don't know."

*Donald Rumsfeld, 2002*

## Topics for discussion

- Existing legal issues
  - Prime brokerage, futures trading, *etc.*
  - Client money and assets
  - Securities settlement
  - Terminating existing agreements
- Potential future legal issues
  - Central bank discretion to transfer assets
  - New concepts of “banking”
  - Characterisation of credit derivatives

Existing legal issues –  
Prime brokerage, futures trading, *etc.*

- Who is the client of the prime broker?
- Assumptions made that the counterparty will not become insolvent
- One-sided default provisions
- Termination rights under legal documentation (see below also)
- Governing law

## Existing legal issues – Client money and assets

- Client money rules under MiFID
- Effect of rehypothecation
- Who has legal title to the assets (securities) of the Prime broker’s client?
- Does the client have a proprietary claim to money and/or assets?
- Does bankruptcy law have primacy over a financial regulator’s rules on client money and assets?

## Existing legal issues – Securities settlement

- Failed trades
  - On-exchange trades vs. OTC
  - Freezing of system upon Lehman insolvency
  - Why has the normal mechanism for settlement fails not operated?
- Market practice vs. legal documentation
  - Lack of clarity as to actual contractual arrangements between brokers and clients

## Existing legal issues – Terminating existing agreements

- Force majeure
  - Financial crisis as a force majeure event? (*Donald Trump v. Deutsche Bank*)
- Material adverse change (MAC)
  - Particularly relevant for bank funding commitments
  - Preferable to be at subjective opinion of bank rather than objective test
- Anticipatory or repudiatory breach
  - Permits termination where a party can show the other party will not perform e.g. due to deterioration of financial position, or where party indicates refusal to perform
  - Lehman – lack of certainty

# Potential future legal issues – Central bank discretion during crisis

- Case study – UK Banking Act 2009: UK authorities have the ability to transfer all **or part** of a failing bank to a private purchaser, a “bridge bank” or into temporary public ownership
- Effect on set-off and netting
  - A bank customer could not be sure of efficacy of netting its exposures to the bank; therefore have to account for exposure on gross, not net, basis
- Effect on security arrangements
  - A transfer of a bank’s liability, without transfer of collateral, could cause the security arrangement to fail
- Effect on structured finance and covered bonds
  - A partial transfer of contracts could upset the “true sale” requirements for structured finance

## Potential future legal issues – New concepts of “banking”

- “Utility banking” vs “investment banking”
- The effect of the Single Euro Payments Area (SEPA), and the Payment Services Directive on retail banking
  - New entrants into retail money business (debit card, e-money, mobile phone money transfer, etc.)

# Potential future legal issues – Characterisation of credit derivatives

- Current focus on central clearing counterparty (CCP); standardised CDSs
- But CCP is only the first step; does not suit all CDSs or other types of derivatives
- Direct product regulation?
- Credit derivatives vs. insurance
  - (US) Draft bill – Derivatives Markets Transparency and Accountability Act of 2009
    - Aims to prevent “naked swaps”
    - Requires protection buyer to have direct exposure to loss
    - Effectively converts the CDS into an insurance contract

# Comments / Questions / Discussion

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