

**CADWALADER**

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Symposium  
Lessons of the Lehman Failure  
From the Perspective of an  
"Outside" Lawyer

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# Lead up to Lehman Failure (Outside Lawyer's Perspective)

- Increase in number of questions: what happens if...
  - a broker-dealer fails?
  - stock is not delivered?
  - I can't move my positions?
  - the holding company fails, can the broker-dealer survive?
- Surprisingly (to a lawyer), concern from investors is less about being made whole, than (i) how quickly is it possible to regain control of positions and (ii) how quickly is it possible to know what the positions are (are the claims still in the form of securities positions exposed to the market or are they cash claims)?

# Lead up to Lehman Failure (Action Steps)

- **Decision: Be (i) financially prudent and panic or (ii) attempt to maintain goodwill of dealer by maintaining positions**
- **Try to get information on location of positions. Where are they? Legal status of them? Rights? How much “excess” collateral in the account? Can excess collateral be transferred? What procedures for transfer?**
- **Attempt to “ACATS” positions from one broker-dealer to another -- high degree of randomness in success of this— issue as to whether it is possible to transfer non-fully paid securities (inter-dealer settlement risk)**
- **Reduce value of exposure: transfer out money or securities; borrow cash**

# Lead up to Lehman Failure (Action Steps) (cont'd)

- **Sell out or buy-in positions: go to cash and reduce exposure to market (Customer claims are based on trade date positions)**
- **Close-out of derivatives and re-open elsewhere – pricing, timing, exposure issues**
- **Tremendous size of intrading unsecured exposures; many (not all) related to FX or cross-border transaction; demand collateral for unsecured financings; cross-collateralization; parent company guarantees**
- **Stop doing business – not worth risk or uncertainty of delay even on protected contracts**

# Lead up to Lehman Failure (Action Steps) (cont'd)

- **Trading intermediation arrangements stopped (CDS prime brokerage)**
- **Withhold deliveries or payments – risk of making a one-way settlement; better to owe than be owed**
- **Demand return of loaned securities, close out of repos**
- **Default securities loans and repos on the basis of delivery failure**

# Lead up to Lehman Failure (Action Steps) (cont'd)

- **Default bankrupted entities**
- **Cross-default non-bankrupted entities, if possible**
- **Value defaulted agreements**
- **As an alternative to defaulting, withhold performance**

# Uncertainties for Customers

**Without knowledge, impossible to adequately assess risk and respond**

- **Customers did not understand custody rules and risks**
- **Did not know governing legal regime**
- **Valuation**
- **Open-ended ability of trustee to transfer accounts in whole or part**
- **Procedures for release of liens**
- **Procedures for settlement of open trades**

# Lessons of SIPC

- Safe harbors generally worked well,
- SIPC stay was quickly released (any need for it?)
- Broker-dealer “customer protection rule” (Rule 15c3-3) generally works well – basically clever structure, but:
  - OTC option and “TBA” counterparties not given warning that they were not customers
  - All short positions were closed out at time filing...inevitable in retrospect, but a surprise to the market
  - Size of the task beyond resources of relevant entities
  - Uneven communication

# Problems Going Forward

- SIPC “optionality” creates an inability to manage post-petition market risk
- Valuation of positions
- Location of collateral
- Cross-liens
- Cross-border issues
- Subcustodians

# Problems Going Forward

- **Loss of confidence will lead to faster panic reactions**
- **“Improving” agreements for one party often results in systemic worsening**
  - **Loss of lock-ups**
  - **Shortening of maturities**
  - **Increased “default” triggers**
  - **Increased demands for contractual “fixes” to prime brokerage agreements that create greater uncertainty under SIPA**

# Fixes Going Forward

- **Mini-Close Outs on Delivery Failures**
- **Encourage 2-way Margining on Derivatives/Financings**
- **Permit Securities Loans to be for Term**
- **Transparency in Collateral Holding and Movement Arrangements – Disclosure of Legal Risk**
- **Appropriate Allocation of Custody Risk – Not All on Dealer**
- **Governmentally Created or Directed “BCP” Task Force to Deal with Insolvencies**
- **Mechanism to Deal with Herstatt risk**
- **Limited Governmental Guarantees**
- **In Broker-Dealer, Consider Separation of Cash Accounts from Margin Accounts for Bankruptcy Purposes**