ABI Reform Commission
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Consideration Should be Given to the Impact of the Safe Harbors on a Debtor Post-Petition; the Benefit of Safe Harbor Protections Should be Tied to an Obligation to Inform the Estate of the Closeout of the Transaction

A laudable goal of the safe harbor provisions is to assist the financial markets by encouraging continued transactions during periods of distress. This goal was to a significant degree met during the worst periods of the financial crisis, as thousands of counterparties continued to do business with struggling institutions, providing transaction flow and liquidity that may have helped prevent additional firm failures.

However, in the event of a failure, particularly a financial firm failure, the safe harbors as currently drafted do little to assist the debtor in understanding the impact of counterparties who exercise their safe harbor rights. This has been manifest in my experience leading the liquidations of Lehman Brothers Inc. and MF Global Inc., where several hundred counterparties availed themselves of safe harbor protections on instruments involving tens of billions of dollars.

Ultimately, the unwinding of these financial products, including repurchase and reverse repurchase transactions, securities lending transactions, derivatives transactions, and to-be-announced mortgage transactions, has resulted in over $4.5 billion in assets marshaled for the two estates. However, with a few exceptions, this process has been arduous and expensive. The excellent results for the estates come only out of an aggressive and innovative asset collection regime tailored in connection with the advice from the Securities Investor Protection Corporation

and input from regulators; a regime that future estates may not necessarily be in a position to establish, or to fund.

Current law provides little incentive for counterparties to self-report to a debtor and in my experience, with perhaps exception for an auditor's demand to maintain a reserve, few do. At best, counterparties have no reason to report their termination values to the estate and wait for a demand letter, Rule 2004 subpoena, or an adversary proceeding to begin a dialogue. At worst, counterparties frustrate a debtor's attempt to marshal estate property, by withholding information to gain a financial advantage.

I recommend that the Commission consider tying a reporting requirement to the exercise of safe harbor rights, and I suggest some particularized considerations in the context of clearing banks of a broker-dealer.[1] Such reporting requirements may help further the policy goals of the safe harbors both pre *and post* petition, as speeding the return of estate property can only help expedite distributions and therefore return of capital to the marketplace.

A. The Debtor's View of a Closeout – Consideration of a Reporting Requirement

My experience on the debtor side includes the closeout of all forms of financial products, including foreign exchange derivatives, repurchase and reverse repurchase agreements, securities lending agreements, and to-be-announced and other forward transactions. Nearly all the counterparties are highly sophisticated market participants that engaged in complex transactions worth millions or even billions of dollars and, as such, are fully aware of (i) their rights and obligations regarding the closeout of transactions, and (ii) their financial exposure to the estate resulting from the closeout, including whether an estate receivable or payable exists.

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1. There are other valuable lessons from the liquidations of Lehman Brothers Inc. and MF Global Inc. that are covered in the Trustee's investigation reports to the Honorable James Peck, U.S.B.J. (Case No. 08-01420 (JMP) (SIPA)) and the Honorable Martin Glenn, U.S.B.J. (Case No. 11-2790 (MG) (SIPA)), which I incorporate by reference for the Commission's consideration.

While solvent, functioning counterparties may have this information readily available, in practice estate professionals can be required to expend tremendous effort and expense to determine which counterparties had payables to the estate, send inquiry or demand letters to such counterparties (if not subpoenas), and then conduct the reconciliation of the outstanding accounts. Even then, many of the counterparties can be slow to respond to requests for information or support for their closeout calculation, and subpoenas and/or litigation may be necessary.

For example, in the first year of the Lehman liquidation while the trustee and his professionals had many other pressing tasks and were grappling with informational problems, collections from financial product unwinds totaled approximately $500 million. In contrast, once preliminary review of the books and was completed, recoveries totaled four times as much — over $2 billion — between August of 2009 and August of 2010. In total, over a period of nearly four years, that total has increased to $4.3 billion.

The additional expense to an estate in having to investigate and search for potential receivables due from the unwind of financial products is considerable. In Lehman, I estimate that over 100,000 hours of professional time had to be expended in locating and researching amounts potentially owed by counterparties, contacting those counterparties, convincing them to share necessary information, and negotiating with them to effect payment of amounts that they, themselves, sometimes recognized they owed to the estate. Much of this could have been avoided through provision of basic information by counterparties.

The possibility also exists that, if parties in possession of the information and aware of the transactions do not come forward, some receivables may be missed because of the complexity of the debtor's records, erroneous or confusing listings, or even market movements

that a debtor may not be in a position to track. For example, the books and records of the debtor may indicate a small receivable or even net payable when in fact the counterparty owes substantial funds to the debtor. In one instance, due solely to a collection effort some may deem overly aggressive, estate lawyers and accountants pursued a counterparty for which Lehman's books and records showed a payable of $10 million, and uncovered a $35 million receivable to the estate. This was achieved two years into the liquidation — notably, two audit periods after the counterparty's automatic acceleration, with a reserve established.

To aid future debtors, I recommend that within a period such as the bar date, financial product counterparties be required to provide the debtor, trustee or other liquidator information regarding their terminated transactions, together with summaries setting forth: (i) the trade information, closeout date and amount believed to be owed; (ii) any collateral or other property of the estate being held by the counterparty; (iii) the valuation statements and the methodology employed in calculating valuation; and (iv) the nature and amount of any setoff or other deduction or adjustment the counterparty intends to assert. The submissions should include a representation by the counterparty that the submission is a complete list as well as copies of supporting contractual documents. In that connection, I recommend counterparties also provide what transactions they did not terminate and identify any collateral held.

The debtor should in turn provide to financial product counterparties, if possible, and post on its own and others', such as SIFMA's, websites: (i) the updated mailing address to which the counterparties should send a copy of their termination notices, valuation statements, notices of default and other correspondence; (ii) the updated bank/securities account(s) information to which counterparties should make payments of cash or transfer of securities, as

applicable, and (iii) the name and address of the trustee's or other liquidator's legal counsel to whom legal questions should be directed.

A debtor should also (i) implement a standardized format (as determined by the financial/accounting professionals) as to the type of information that should be provided for each financial product, and (ii) require that such reconciliation information, in addition to hard copies, be provided in a modifiable electronic format, *e.g.*, excel format (no pdfs).

Finally, consideration may be given to establishing an appropriate interest rate to apply to the return of estate property. Contractual interest rates varied and in many instances were nonexistent, which alone became a time consuming part of reconciliation and negotiation that delayed, in my view, the return of several hundred million dollars by many months. Standardization may help eliminate some of this delay, and would further assist a debtor in collection efforts.

B. Special Considerations for Clearing Bodies

Clearing banks hold enormous amounts of collateral which, under current safe harbor provisions, they are able to hold or liquidate with little or no visibility or accountability until well into a bankruptcy. These entities need security and should not be prevented from exercising legitimate rights of secured creditors. However, there should be visibility for the estate and accountability by the clearing entity in contemporaneous fashion.

In the critical early days of the Lehman and MF Global failures, we had limited or no access to data screens at clearing banks. This resulted in the estate expending substantial resources to identify the ownership and interest in securities that were part of trades or other transactions.

To remedy this challenge for future estates, the bilateral information systems on which a broker-dealer relies in conducting business with its clearing bank should maintain

visibility to information even if electronic trading access to accounts is cut off or activity in the accounts is frozen.

Future liquidators should be provided with continuous, unimpeded access to systems that monitor activity, and transmission of information by clearing banks should be continued without interruption on the same basis as prior to the bankruptcy. This information flow should include daily reports identifying (i) CUSIP-level detail of securities transactions that will occur post-filing, including trade settlements and unwinds of repurchase transactions, covering both the debtor's outgoing obligations and anticipated receivables and (ii) securities that the clearing banks have liquidated. Requiring clearing banks to maintain systems visibility will ensure that any actions taken in their capacity as creditors of the estate are done with complete transparency and accountability.