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CLIENT UPDATE*

The following is a general overview of the insolvency procedures and customer protections that would be applicable in the event a prime broker is put into a liquidation proceeding under the Securities Investment Protection Act (“SIPA”), or an affiliate of a prime broker (including the parent) becomes involved in insolvency proceedings, under SIPA or otherwise.

Appointment of a SIPA Trustee and Transfer of Customer Assets.

Once the SEC determines that a broker-dealer has failed or is in danger of not meeting its obligations to its customers and that the broker-dealer is insolvent, or cannot demonstrate its compliance with the SEC’s or any self-regulatory organization’s rules, the SEC will file a petition in the United States District Court to appoint a trustee under SIPA to allocate customer property in accordance with the SIPA statute, as well as to liquidate the assets and pay the claims of creditors of the insolvent broker-dealer. The District Court will immediately appoint a SIPA trustee, and the case will be referred to the Bankruptcy Court which will preside over the SIPA liquidation. SIPA will govern the liquidation of the broker-dealer while the Bankruptcy Code will govern the liquidation of the broker-dealer’s affiliated non-broker entities (including its parent) that are used to engage in swaps, forwards, commodity contracts, repos and securities lending or to guarantee the counterparty’s obligations thereunder. If the bankrupt entity is not a U.S. corporation, the liquidation will be subject to the insolvency laws of another jurisdiction.

* This *Client Update* is not legal advice. Should you wish legal advice with respect to the matters discussed herein, please contact us.

Upon its appointment, the SIPA trustee has the right to transfer any customer accounts and the securities and cash positions therein to another broker-dealer without the consent of the customer. This would most likely occur early on in a proceeding where it appears that the insolvent prime broker was substantially in compliance with the SEC customer protection rules. In such a case, customers should be able to trade the securities in their accounts and have access to their cash at the new broker-dealer within five to seven business days.

Liquidation Proceedings.

Even if no customer accounts are transferred, a hedge fund customer has some significant protections available to it in a SIPA liquidation proceeding, including the fact that any customer trading on margin is permitted to offset what the customer owes to the bankrupt broker-dealer against its claims to any securities that the firm is holding for the customer, notwithstanding any automatic stay that applies to the broker's creditors. Similar rules protecting customer rights to terminate, net out and realize on collateral apply to repurchase agreements, forward contracts, securities lending, commodity contracts and swaps with any affiliated counterparty (even if the counterparty is not registered with the SEC as a broker), if the arrangements are governed under standard ISDA agreements.¹

¹ If a customer is holding cash collateral pledged to it by the insolvent prime broker to secure the broker's obligation to deliver securities, or by an affiliate of the prime broker to secure its performance of its swap obligations, SIPA permits the customer to immediately apply that cash to reduce its loss exposure to the prime broker. However, if the customer is holding securities collateral posted by the prime broker, including securities held pursuant to repurchase agreements or securities lending arrangements, the stay against any immediate liquidation of its collateral will apply in order to give the SIPA trustee an opportunity to value this collateral. SIPC has stated its policy will be to permit liquidation of securities collateral within a few days after commencement of liquidation once it has satisfied itself as to the value of the securities and the absence of any indications of fraud.

Customer Property and Claims in SIPA Proceedings.

Securities deemed to be “customer property” (including street name securities held by DTC²) would be allocated among the accounts of other similarly situated customers holding securities of the same issue and series to the extent of their respective “net equity claims,” as determined by the value of the securities and the cash in the account on the date the liquidation proceeding commences less any amounts owed to the broker-dealer. Customer property (including stocks, bonds, options on individual securities, groups of securities, or on a securities index, security future, and cash, but excluding foreign exchange transactions, futures, options on futures, commodity contracts, precious metals contracts or any investment contracts not registered as securities) would be pooled separately and not be subject to claims of the insolvent broker-dealer’s general creditors. Eventually, each customer would be entitled to receive customer property up to the amount of its “net equity claim,” from this pooled customer property, in kind, to the extent securities are available. In the event a customer suffers a loss because the customer property it receives is less than its net equity claim, the loss is covered by the SIPC Fund up to \$500,000 (of which a maximum of \$100,000 is available to cover cash losses).³ To the extent of any loss in excess of the SIPA limit, the customer is entitled to a general unsecured claim in the SIPA liquidation of the broker-dealer. We also understand that

² Under SIPA, the trustee is required to deliver to the customer any “customer name securities” held by a broker-dealer. This obligation only applies to securities that are registered in the customer’s name as opposed to street name. The customer’s right to the delivery of these securities is separate and apart from its claim to customer property for securities held in its account in street name. As a practical matter, hedge funds will not have any securities registered in their own name because the process of registering and reregistering any securities in customer name is time consuming and will inhibit the ability to trade or borrow against such securities.

³ The SIPC Fund is an industry-sponsored fund with close to \$2 billion in assets and the ability to borrow an additional \$1 billion from the United States Treasury.

many prime brokers have arranged for private insurers such as CAPCO to issue a surety bond to cover losses in excess of the SIPA limit up to a specified amount for each customer.

Non-SIPA Proceedings.

The bankruptcy liquidation of any affiliated entities organized under U.S. law that are not banks or registered with the SEC as brokers will proceed under chapter 7 of the Bankruptcy Code. Unlike the SIPA proceeding, the bankruptcy trustee is required to reduce all assets to cash. Thereafter, the customer property rules will apply, but will effectively discriminate in favor of securities customers. Thus, “customers” whose accounts contained securities (defined as above) will receive a priority allocation in the cash received upon liquidation of their assets while those “customers” who had foreign exchange, futures or commodity contracts, will be general unsecured creditors.

ISDA Swap Provisions.

If a Bankruptcy as described (broadly) in Section 5(a)(vii) of the ISDA Master Agreement occurs in respect of a swap counterparty, the other party to the swap (i.e., a customer) would generally have the right under Section 6(a) to terminate all swap transactions with that entity immediately or on a date chosen by the customer not more than 20 days after the notice. The foregoing assumes that Automatic Early Termination is not specified to be applicable in the relevant ISDA. Absent special circumstances, giving a notice of termination as soon as possible would ordinarily be desirable, but a short delay should not prejudice a customer’s rights in a bankruptcy proceeding. However, any such notice cannot be effective as of a date prior to the date the notice is received by the bankrupt entity.

Section 6(e) and the definitions of Settlement Amount and Close-out Amount provide for the netting of all obligations under the ISDA, based upon Market Quotation or Loss (as defined in the 1992 ISDA) or Close-out Amount (as defined in the 2002 ISDA). If the Settlement Amount is owed to the customer and the customer holds collateral (which could be the case if the Credit Support Annex provides for bilateral collateralization), the customer would be allowed to immediately set off the Settlement Amount against such collateral since the "automatic stay" in the Bankruptcy Code does not apply to swaps.⁴

ISDA Master Agreements often have set-off provisions that would allow a customer to set off any obligation the bankrupt entity owes to the customer or any of the customer's affiliates (under the ISDA or otherwise) against any obligations owed by the customer or any of the customer's affiliates to that bankrupt entity. To the extent the other obligations involved in the set-off are not swaps, forwards, commodity contracts, repos or securities loans, the automatic stay may apply to any such set-off against obligations outside the ISDA.

If the customer does not hold collateral, or at least not enough collateral, to pay off the amount the bankrupt entity owes to the customer, it would be a general creditor of that entity for the shortfall, and the timing of the customer's recovery, if any, would depend on the bankruptcy proceedings.

If the customer has posted collateral with the bankrupt entity in an amount in excess of its obligations to the bankrupt entity, which could arise out of the posting of up-front Independent Amounts of collateral, the customer may have to participate in the bankruptcy

⁴ Similar protection may exist for customers which have forwards, commodity contents, repos or securities loans in effect with a bankrupt entity.

proceedings to argue that the customer was not extending credit to the bankrupt entity but rather that the bankrupt entity was a custodian of the collateral which belongs to the customer. Even if the customer is successful in its position, any recovery of such excess collateral by the customer may be substantially delayed.

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