

# International Financial Products and Services Committee Newsletter

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## Message from the Chair

It is with great pleasure that we are proud to release the first issue of the Newsletter of the Financial Products and Services Committee and we do hope that you will find the content of the articles included in this issue useful for your practice.

All members are hereby encouraged to send submissions for our future issues. The Committee's Newsletter intends to focus on topical issues in international legal, regulatory and supervisory issues related to international financial institutions, including firms that provide banking, capital markets, investment and insurance products and services. Topics of interest include but are not limited to: international and comparative regulation of products and services; compliance with anti-money laundering and terrorist financing laws; resolution of financial disputes; new developments in regulatory and capital schemes; and practical issues in advising international financial institutions.

Last but not least, we would like to bring to your attention the excellent job done by Tom Pepevnak, our Editor, and Tally White, who worked together to enable us to have this first issue! Thank you very much, Tom and Tally!

Best Regards,

Walter Stuber, Co-Chair, Financial Products and Services Committee, Finance Division, ABA Section of International Law.

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# Canadian Approach to Restructuring Frozen ABCP

## How market participants worked together to complete the Montreal Accord Restructuring

By Philip J. Henderson and William A. Scott of Stikeman Elliott LLP (Toronto)

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The so-called “third party” (or non-bank sponsored) portion of the asset-backed commercial paper (ABCP) market in Canada largely collapsed in August 2007. Market participants and other stakeholders stood still and worked together from August 2007 through January 2009 to achieve an unprecedented consensual restructuring of these debt securities.

### Rise of the Third Party ABCP Market in Canada

The ABCP market in Canada had for many years funded the purchase of traditional securitized assets by bank sponsored conduits. Late in the 1990s, third party (or non-bank sponsored) conduits also began to appear in the ABCP market in Canada.

One feature of the Canadian ABCP market that has now garnered much attention is so-called Canadian-style “general market disruption” liquidity. Unlike in ABCP markets outside Canada, where “global style” liquidity is prevalent, liquidity backstop facilities (funding the mismatch between ABCP maturities and the maturities of the underlying securitized assets) in Canada have traditionally taken the form of general market disruption liquidity, where the condition precedent to draw is a market wide liquidity event unconnected to the creditworthiness of the particular ABCP conduit. One theory is that the general market disruption standard became prevalent in Canada because the Office of the Superintendent of Financial Institutions (OSFI), the federal financial institutions regulator, allowed Canadian banks a zero capital charge on the undrawn portion of pure liquidity lines (i.e., those adopting the “general market disruption” standard). When third party (or non-bank sponsored) conduits began to appear in the ABCP market in Canada, they also adopted the general market disruption standard in their liquidity arrangements. DBRS Limited (DBRS) has traditionally been the only rating agency to rate ABCP in Canada, whether bank sponsored or non-bank sponsored, at least in part because other rating agencies required “global style liquidity” as part of their ratings criteria.

Beginning in 2003, ABCP conduits in Canada began acquiring structured credit assets in addition to traditional securitized assets. Structured credit assets took the form of credit default swaps (CDSs) and credit linked notes (CLNs) and were often tranching as collateralized debt obligations (CDOs), giving ABCP conduits access to premium income from credit arbitrage opportunities. The third party ABCP conduits in Canada participated significantly in these credit arbitrage opportunities, including in leveraged super senior (LSS) transactions. Global financial institutions as well as Canadian banks participated in providing both structured credit assets and liquidity facilities to Canadian ABCP conduits.

LSS transactions provided ABCP conduits with a leveraged exposure to the super senior tranche of a reference portfolio of credit assets. Much has been written about LSS transactions so we will not repeat the details of these types of transactions here. However, it is noteworthy for purposes of this article that an LSS transaction requires the protection seller to de-lever the transaction by posting additional collateral to the protection buyer whenever predetermined collateral triggers are crossed (for example, based on the mark-to-market exposure of the protection buyer, levels of losses in the reference portfolio or increases in index

spread levels or loss levels, but generally based on the widening of relevant credit spreads). ABCP conduits then must fund the posting of additional collateral, through the issue of additional ABCP or other notes, or face default under the terms of the LSS transaction. Many LSS transactions entered into by the ABCP conduits were levered five or ten times or more in response to premium compression in the market.

By 2007, there were at least 22 third party ABCP conduits, sponsored by at least six different structured finance boutiques and several bank-owned securities firms, participating in structured credit transactions in Canada. These ABCP conduits had established, collectively, nearly one hundred separate so-called "satellite trusts" for the purpose of holding particular structured credit assets. Outstanding ABCP issued by these conduits totalled approximately CDN \$34 billion, including approximately CDN \$22 billion supporting LSS transactions.

### **The Liquidity Crisis and the Montreal Accord**

In the summer of 2007, increasing concerns about the North American credit markets and, specifically, exposure of the financial sector to U.S. sub-prime mortgage loan risks, spread to Canada and major investors in third party ABCP in Canada became concerned about potential exposure of third party ABCP to U.S. sub-prime mortgage loan risk. Although there was some information in the marketplace and in DBRS publications about the assets of these third party ABCP conduits, information was limited as the third party ABCP market in Canada had developed as a prospectus exempt market on a relatively non-transparent basis. ABCP conduits themselves were not subject to statutory disclosure obligations of any kind. In July 2007, one of the third party ABCP conduit sponsors provided additional information about its U.S. sub-prime mortgage exposure to the investment dealers that distributed its ABCP. Although the percentage of total assets supporting its outstanding ABCP with such exposure was relatively low (approximately 4%), the disclosure appeared to increase rather than abate concerns among holders of third party ABCP.

Credit spreads continued to widen throughout the summer of 2007. On August 13, 2007, investors in third party ABCP refused to roll their notes and many of the third party ABCP conduits issued liquidity demands to liquidity providers who, in most cases, declined to provide liquidity on the basis that the relevant preconditions (i.e., typically "general market disruption" or some variation) for liquidity advances had not been satisfied. Many of the liquidity providers to the third party ABCP conduits were either the LSS CDS counterparties facing the conduits or their affiliates. A number of the LSS CDS counterparties also made collateral calls on third party ABCP conduits and satellite trusts. This pattern was repeated on August 14 and 15.

Faced with defaulting ABCP and a rapidly escalating crisis, a number of key participants, including major holders of third party ABCP and CDS counterparties, met in Montreal on August 15 and overnight hammered out a two page standstill arrangement which became known as the "Montreal Accord". The Montreal Accord proposed an interim solution that would address impending defaults on LSS CDS transactions (it being believed that such defaults would result in significant losses for holders of third party ABCP) while longer term solutions could be worked out. Essentially, the Montreal Accord provided that the signatories would work together in good faith to implement a restructuring of all outstanding third party ABCP by converting it into floating rate term notes and observe a standstill period (during which no liquidity calls would be made by the ABCP conduits and no collateral calls would be made by the asset provider signatories, and after which standstill period no liquidity calls would be made by the ABCP conduits for a further 150 days) to allow all relevant stakeholders to focus on the restructuring. The Montreal Accord also envisioned revisions to collateral provisions to reduce the likelihood of near term collateral calls. It was contemplated

(somewhat optimistically as it turned out) that the restructuring could be completed within 30 to 60 days.

On September 13, 2007, DBRS announced that it had updated its rating criteria for Canadian ABCP programmes and would require all new trusts issuing ABCP to have global style liquidity.

### **The Investors Committee**

The restructuring effort began in earnest with the formation in September 2007 of the Pan-Canadian Investors Committee for Third Party Structured Asset-Backed Commercial Paper (the Investors Committee) and the retention of JPMorgan Chase and Ernst & Young as advisors. The members of the Investors Committee represented a number of institutional investors and financial institutions collectively holding approximately CDN \$20 billion of outstanding ABCP across some 43 series of notes.

One of the initial challenges facing the Investors Committee was simply to identify and analyze the assets supporting the different series of ABCP, including more than 100 levered and unlevered CDSs with an aggregate notional amount of approximately CDN \$200 billion and approximately CDN \$20 billion of related underlying collateral (a significant portion of which was the subject of total return, interest rate and/or currency swaps with the CDS counterparties), some CDN \$11 billion of traditional securitized assets such as pools of credit card receivables, mortgages and car loans/leases and related hedging contracts, miscellaneous securities and cash on hand.

Given that the CDSs were generally bilateral contracts between an asset provider and an ABCP conduit or satellite trust, the precise terms of the CDSs were not immediately available to the Investors Committee or its advisors. The confidential nature of the terms of these bilateral contracts was the subject of some concern. Given those confidentiality concerns, a veritable spider's web of interconnected confidentiality agreements was negotiated among the parties to permit the identification and analysis process to occur. Similar difficulties were encountered in identifying the beneficial holders of the ABCP and in disclosing details of the traditional securitized assets.

### **The Restructuring Plan**

Following extensive negotiations among the interested parties, a Framework Agreement was announced by the Investors Committee on December 23, 2007.

A variety of restructuring alternatives had been considered. The parties ultimately settled on a potentially court-supervised process that would involve the division of assets between three separate Master Asset Vehicles (MAVs). Where the assets of the legacy ABCP conduits included both CDSs (and related collateral) and traditional securitized assets, they were to be pooled in MAV1 and MAV2, with additional collateral in the form of approximately CDN \$1.4 billion of cash on hand and CDN \$13.4 billion of margin funding facilities being required. These assets were allocated between MAV1 and MAV2 based upon noteholders' previous holdings in the legacy ABCP conduits. To ensure fairness among the holders of different series of notes, a "relative contribution analysis" was developed by JPMorgan which valued the assets underlying each series of legacy ABCP.

Certain large ABCP holders who would exchange their ABCP for new notes of MAV1 agreed to provide their own margin funding facilities of CDN \$8.3 billion. These large ABCP holders comprised a small number of large institutional investors and financial institutions that had the credit ratings necessary to support their self-funding of the MAV1 margin facilities. All other ABCP holders exchanged their ABCP for new notes of MAV2 and/or MAV3. Margin funding facilities of CDN \$5.1 billion were to be provided to MAV2 by a combination of Schedule I

Canadian banks and a number of the LSS CDS counterparties facing MAV2. Of this amount, some CDN \$1.05 billion was provided by Schedule I Canadian banks.

In the case of MAV1 and MAV2, assets that had significant U.S. sub-prime exposure would not be eligible as additional collateral for the LSS CDSs, so the MAVs would issue asset-by-asset tracking notes in respect of these assets. The assets of legacy ABCP conduits holding exclusively traditional securitized assets were to be transferred into MAV3 and further asset-by-asset tracking notes were to be issued by MAV3.

In exchange for the additional collateral for their LSS CDSs and to provide increased transparency, the LSS CDS counterparties agreed that their ability to call for additional collateral (and, indirectly, on the margin funding facilities) would depend on hitting spread/loss matrix triggers linked to publicly quoted indexes. Once the margin funding facilities were exhausted, unless further collateral was provided, the LSS CDSs could be terminated and the underlying collateral liquidated. As credit markets continued to deteriorate in the following months, various modifications to the structure, to address increased proximity to the spread/loss triggers, were agreed by the parties.

### **Novel Use of the CCAA**

On March 17, 2008, a plan of compromise and arrangement (the "Plan") under the *Companies' Creditors Arrangement Act* (Canada) (CCAA), the functional equivalent of Chapter 11 proceedings in the United States, was filed by the Investors Committee with the Ontario Superior Court of Justice (the CCAA Court). The Plan provided for the restructuring of the assets and liabilities of 20 insolvent ABCP conduits in the manner described above and, once approved, would be binding on all holders of affected ABCP.

One potential obstacle to the Plan was that the CCAA had not previously been used to restructure common law trusts (as opposed to companies). However, the CCAA Court accepted that the trustees of the trusts, if they otherwise qualified for restructuring under the CCAA, could be regarded as "debtors" for CCAA purposes. In order for the affected ABCP conduits to qualify for restructuring under the CCAA, it was therefore necessary to replace the existing trustees that were companies incorporated under the *Loan and Trust Corporations Act* (Canada) (i.e., professional trust companies, which could not themselves be subject to restructuring under the CCAA) with newly incorporated business corporations.

Since the swaps between the CDS counterparties and the affected ABCP conduits were "eligible financial contracts" within the meaning of the CCAA, rights of termination and enforcement against the collateral held by the ABCP conduits and satellite trusts were not subject to the CCAA stay order. This risk for the Plan was dealt with through a support agreement pursuant to which the CDS counterparties supported the Plan but preserved their right to walk away from the Plan and enforce their contractual rights in prescribed circumstances.

In the Information Statement dated March 20, 2008 prepared in connection with the required meeting of ABCP holders, the Investors Committee did not express a view regarding the value of potential litigation claims against liquidity providers who declined to fund in August 2007. They noted that the outcome of any such litigation would depend upon the specific language of the liquidity agreements and the surrounding factual circumstances, stated that "it is reasonable to proceed on the basis that any such litigation would be, in all likelihood, protracted and expensive, and have an uncertain outcome", and concluded that the Plan constituted "on balance a reasonable commercial compromise contributing to the benefit of Noteholders on an overall basis".

The most controversial element of the Plan was a blanket release from liability for all parties in any way involved with the third party ABCP conduits subject to the Plan, including in respect of any allegedly fraudulent conduct. Proponents of the Plan justified the release on the basis that, while it precluded claims against solvent third parties, it was necessary in order to persuade numerous participants to support the Plan (e.g., by modifying collateral triggers and providing margin funding facilities to the MAVs, which were essential to the success of the Plan) and to ensure certainty and finality. The release was challenged by a number of affected ABCP holders as an unlawful expropriation of property (in the form of their litigation claims) and on the basis that it was outside the jurisdiction of the CCAA Court to sanction releases in favour of solvent third parties. The CCAA Court found that a plan of compromise and arrangement could include releases in favour of solvent third parties where the releases are reasonably connected to the proposed restructuring.

On April 25, 2008, the Plan was approved by a double majority of some 96% in number and by value of the holders of affected ABCP voting as a single class. In this regard, the CCAA Court held, despite some challenges, that the interests of the holders of the affected ABCP were sufficiently similar to warrant voting as a single class rather than as 43 separate series. However, as a condition of sanctioning the Plan, the CCAA Court required that the question of fraud claims be revisited. The Plan participants agreed to modify the Plan to exclude fraud claims from the blanket release in limited circumstances. The Plan was sanctioned by the CCAA Court on June 5, 2008.

The terms of the release were again challenged by certain dissident noteholders, mostly corporates who were not eligible to participate in certain relief plans made available by several brokerage firms to “retail” noteholders holding less than CDN \$1 million of ABCP. Notwithstanding such challenges, the Ontario Court of Appeal unanimously found on August 18, 2008 that, as modified with the fraud claims carve-out, the release was lawful and the Plan was fair and reasonable in the circumstances. A further application was made to the Supreme Court of Canada (SCC) alleging that the release raised issues of national importance, but the SCC refused to hear an appeal. In the result, no claims based upon the fraud carve-out to the Plan release were ever filed.

As conditions in the global credit markets continued to deteriorate to historic levels, the Investors Committee requested in the late autumn of 2008 that the margin call triggers be made even more remote. While the LSS CDS counterparties were prepared to move the triggers if additional collateral was provided, the issue became how this additional collateral was to be sourced and on what terms. Ultimately, in an agreement announced on December 24, 2008, the governments of Canada and of the provinces of Quebec, Ontario and Alberta, as well as the Caisse de dépôt et placement du Québec, undertook to make some CDN \$3.45 billion of additional senior margin funding facilities available for a period of 19 months and the margin funding providers in MAV1 agreed to increase their existing commitments by CDN \$1 billion. In exchange, the LSS CDS counterparties agreed to an 18 month moratorium on any new collateral calls (although the margin funding facilities were still available to fund payments to CDS counterparties as a result of credit events and swap terminations in prescribed circumstances).

With this last hurdle overcome, the CCAA Court approved the implementation of the Plan on January 12, 2009 and the Plan was implemented on January 21, 2009, some 17 months after the collapse of the third party ABCP market in Canada.

## **Conclusion**

The Plan is noteworthy as the largest court-supervised debt restructuring in Canadian history and is believed to be one of the very few successful private-market restructuring responses to

the worldwide credit crisis. The Plan is also noteworthy in that it is believed to be the first time that the CCAA was used, in essence, to restructure insolvent trusts.

The creativity, cooperation and sophistication of the Canadian courts in addressing the complex issues raised by the ABCP restructuring were key to its success. The CCAA was interpreted with its "broader socio-economic" purposes in mind and the importance of the restructuring to the integrity and stability of the Canadian financial system was repeatedly recognized.

At this point, regulatory responses to the ABCP crisis remain unclear in Canada.

For its part, OSFI issued several announcements in April and June 2008 clarifying its role in the ABCP market. OSFI emphasized that its primary mandate was to supervise federally regulated financial institutions with a view to ensuring their financial soundness and the adequacy of their risk management procedures, in order to protect the interests of their depositors. OSFI stated that it did not have responsibility for overseeing the firms that created the non-bank ABCP, rather they were subject to applicable securities laws, and that OSFI guidelines relating to liquidity facilities, for example, did not apply to the foreign banks that provided the bulk of the liquidity lines to third party ABCP conduits. OSFI also noted that since liquidity lines provided by Canadian banks to conduits have since become "global style liquidity" lines, they carry a capital charge, currently 20%, rather than the zero weighting that applied to "general market disruption" liquidity facilities. In October 2008, OSFI finalized an advisory on expected securitization practices which eliminated the zero capital charge for any "general market disruption" liquidity facilities and confirmed that such facilities would receive the same capital treatment as global style liquidity facilities.

In October 2008, the Investment Industry Regulatory Organization of Canada (IIROC) published a study which contained a description of the development and regulation of the third party ABCP market and events leading up to August 2007, a report on compliance reviews conducted with IIROC dealer members involved in the third party ABCP market to determine what controls and processes were in place and applied to the manufacture and sale of third party ABCP, as well as various findings and recommendations including in respect of product due diligence, product transparency, conflicts of interest and dealer use and disclosure of credit ratings.

Also in October 2008, the Canadian Securities Administrators (i.e., the Canadian provincial and territorial securities regulators) issued a consultation paper which, among other things, solicited comments on:

- (a) implementing a regulatory framework applicable to credit rating agencies that would require compliance with the International Organization of Securities Commissions (IOSCO) code of conduct and require public disclosure of all information provided by an issuer that is used by a credit rating agency in rating an asset backed security;
- (b) amending the short-term debt (i.e., commercial paper) exemption to make it unavailable for sales of asset-backed short term debt, and requiring issuers who sell these products to do so by way of a prospectus or under another prospectus exemption;
- (c) reducing reliance on the use of credit ratings in securities legislation; and
- (d) addressing the roles played by dealers and advisers with respect to asset-backed commercial paper.

The comment period expired on February 16, 2009.

Finally, it remains to be seen whether an active secondary market in any of the MAV notes will develop. While the Investors Committee's intention was to ensure a public company level of transparency and disclosure, the inevitable complexity of the underlying assets and consequent difficulties in valuing the MAV notes, may inhibit active trading. Moreover, since the MAVs are not public companies and their notes are not listed, trading will most likely be restricted to over-the-counter transactions among sophisticated investors.

*Stikeman Elliott LLP acted for seven international financial institutions and their affiliates that were involved in the ABCP restructuring. The comments in this article are the personal views of the authors and do not necessarily represent those of Stikeman Elliott LLP or its clients.*

## Switzerland

By Martin Liebi of Pillsbury Winthrop Shaw Pittman LLP in New York.

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Switzerland's financial industry did in the reporting period not remain unaffected by the financial crisis unfolding worldwide. UBS AG and Credit Suisse Group, the two predominantly globally exposed financial institutions have suffered the most due to their involvement in structured finance. The imploding market values of structured finance assets has not just endangered their Tier-1-capital ratio and equity situation, but also undermined their private banking activities, the most important pillar of their business model. Drastic and creative solutions were required in order to stop the outflow of client money.

UBS AG and Swiss National Bank ("SNB") have reached an agreement to transfer up to USD 60 billion of currently illiquid Collateralized Debt Obligations, Collateralized Loan Obligations, Residential Mortgage Backed Securities, Commercial Mortgage Backed Securities, Reference Linked Notes, Student Loans, Asset Backed Securities, and other Derivatives from UBS AG's balance sheet to a separate special purpose vehicle in the form a "Kommanditgesellschaft für kollektive Kapitalanlage" governed by the Swiss Capital Investment Act ("UBS AG-option"). Most of these assets are governed by U.S. laws, but some of them also by the laws of specific European countries and Japan. UBS AG raised USD 6 billion in the form of a convertible note placed with the Swiss Confederation.<sup>1</sup> The special purpose vehicle will be capitalized with up to USD 6 billion of equity capital provided by UBS AG and a non-recourse loan in the maximum amount of USD 54 billion provided to the special purpose vehicle by SNB. The non-recourse loan is fully secured by the special purpose vehicle's assets which will be controlled by SNB. UBS AG will sell its equity interests to SNB for USD 1 and will have an option to repurchase the equity once the loan is fully repaid for a purchase price of USD 1 billion plus half of the equity value exceeding USD 1 billion. The initial closing has taken place successfully prior to Christmas 2008 and at least one additional closing is scheduled to take place prior to end of March 2009. Many experts considered such a transaction as too complex to succeed in such a short time frame. These critics hailed the route taken by Citigroup in which the U.S. government injected USD 25 billion up-front and guaranteed to cover 90% of the losses on Citigroup's USD 306 billion portfolio of toxic assets after Citigroup absorbed the first USD 29 billion of losses ("Citigroup-option"). Although economically similar, UBS AG-option and Citigroup-option differ legally. The UBS AG-option allows a clear cut and a new beginning without dragging along toxic assets on its balance sheet.

Having had the choice between the UBS AG-option and the Citigroup-option, Credit Suisse Group decided shortly after the successful initial closing of the UBS recapitalization transaction

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<sup>1</sup> Ordinance regarding recapitalization of UBS AG dated October 15, 2008 (SR 611.055).

to go the same route as its compatriot financial institution. Credit Suisse Group has set up a special purpose vehicle on its own to alleviate its balance sheet of currently illiquid assets amounting to USD 5 billion. The units in this special purpose vehicle will be distributed to Credit Suisse Group employees as bonus payments in order to further enhance the alignment of incentives of employees of Credit Suisse Group with incentives of Credit Suisse Group.

## THE BRAZILIAN SOVEREIGN WEALTH FUND

By Walter Stuber and Adriana Maria Gödel Stuber of Walter Stuber Consultoria Juridica (São Paulo, Brazil)

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At the end of last year, immediately before the Christmas holidays, the Brazilian Government enacted Law No. 11,887, of December 24, 2008, approved by the National Congress, which created the Brazilian Sovereign Wealth Fund (*Fundo Soberano do Brasil* – FSB). It should be mentioned that the FSB is very unique and peculiar, with its own characteristics substantially different from those of the traditional sovereign wealth funds existing in other nations. The FSB is compared by those politicians, economists and journalists who question and criticize its creation to the “*jabuticaba*” – a very appreciated fruit that only grows up in Brazil and does not exist in any other part of the world. The current rules applied to the FSB are outlined herein.

The FSB is a special fund of accounting and financial nature, linked to the Ministry of Finance, with the purpose of: (i) promoting investments in assets in and outside Brazil; (ii) forming a public saving; (iii) softening the effects of the economic cycles; and (iv) fostering projects of strategic interest to the country located abroad.

The funds of the FSB shall be exclusively used to make investments, financial or otherwise, for the above-mentioned purpose, in any of the following forms:

I – purchase of offshore financial assets:

- a) through a deposit at a special remunerated account at a federal financial institution; or
- b) directly, by the Ministry of Finance; or

II – by means of paying in units (quotas) of a private investment fund, as provided for in the law.

In this regard Law 11,887/2008 authorized the Union to participate as the sole and exclusive quotaholder of a private investment fund known as Fiscal Fund of Investments and Stabilization (*Fundo Fiscal de Investimentos e Estabilização* – FFIE), to be incorporated by a federal financial institution<sup>2</sup>, very likely Banco do Brasil S.A. The FFIE will be a private nature fund, having its own assets segregated from the assets of its quotaholder (the Union) and subject to its own rights and obligations. The payment of the units of the FFIE shall be authorized by a decree to be proposed by the State Minister of Finance. The purpose of the

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<sup>2</sup> Article 7 of Law 11,887/2008 determines that the incorporation of the FFIE shall be made with due regard to the provisions of item XXII of article 4 of Law No. 4,595, of December 31, 1964. According to such item XXII, subject to guidelines set forth by the President of the Republic, the Brazilian Monetary Council (*Conselho Monetário Nacional* – CMN) shall be the exclusive responsible for establishing rules for the transactions of public financial institutions in order to protect their financial standing and adapt their operation to the objective of Law 4,595/1964.

FFIE must be compatible with Law 11.887/2008<sup>3</sup>. The FFIE will be liable for its own obligations. These obligations will be secured by the goods and rights which form the FFIE's assets and consequently its quotaholder (the Union) will not respond for the obligations assumed by the FFIE. The only obligation of the Union as a quotaholder of the FFIE will be to pay the subscribed units of the FFIE. The winding up of the FFIE shall occur in the form contemplated in its by-laws<sup>4</sup> and upon termination of the FFIE its funds will return to the FSB. By force of law, there will be no federal tax or social contribution on the credit, exchange and insurance transactions or on the earnings and profits of the FFIE. The FFIE shall prepare its accounting statements in accordance with the legislation in force and as contemplated in its by-laws.

The FSB cannot give, directly or indirectly, any guarantee whatsoever because this has been expressly prohibited by the applicable legislation.

The FSB shall pay its own operational expenses.

The investment in financial assets to be made by the FSB shall have a minimum profitability estimated for transaction, determined according to the risk, equivalent to the London Interbank Offered Rate (Libor) for six months.

The FSB shall be regulated by a decree which will establish, among other issues<sup>5</sup>: (i) investment guidelines, setting forth criteria and levels of profitability and risk; (ii) administrative, budget and financial management guidelines; (iii) rules of prudential supervision, observing the best international practices; and (iv) other provisions for the adequate operation of the FSB.

The accounting and income statements of the FSB shall be prepared and determined every six months, pursuant to the terms provided for by the Secretariat of the National Treasury, which is the central accounting body of the federal administration. Every three months, the Ministry of Finance shall send to the National Congress a performance report of the FSB, as contemplated in the regulations of the FSB.

Pursuant to Law 11,887/2008, the proceeds obtained with FSB redemptions shall be exclusively used to soften the effects of the economic cycles and destined in accordance with the annual budgetary law. These proceeds cannot be linked to or used for continued mandatory expenses. The Decision-Making Council (*Conselho Deliberativo*) of the FSB<sup>6</sup> shall prepare a technical report evidencing the relevance of the redemption vis-à-vis the effective macroeconomic scenario.

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<sup>3</sup> This means that the purpose of the FFIE shall be the promotion of the investment in assets in Brazil and abroad, envisaging to form a public saving, to soften the effects of the economic cycles and to foster projects of strategic interest to the country located outside Brazil.

<sup>4</sup> The by-laws of the FFIE shall be approved by its sole and exclusive quotaholder (the Union) by means of the Ministry of Finance and shall also define the investment politics, the criteria and levels of profitability and risk, the operational questions for administrative and financial management and rules of prudential supervision of the FFIE.

<sup>5</sup> Item IV of article 3 of Law 11,887/2008, as approved by the National Congress, refers to "conditions and requirements for paying the units held by the Union in the FFIE" and was expressly revoked by Provisional Measure No. 452, of December 24, 2008, when the law was enacted by the President of the Republic.

<sup>6</sup> The Decision-Making Council shall be instituted by a Decree of the Executive Branch and will be constituted by the State Minister of Finance, the State Minister of Planning, Budget and Management and the President of the Central Bank of Brazil (*Banco Central do Brasil – Bacen*). This decree will govern the attributions, structure and powers (jurisdiction) of the Decision-Making Council, which will be responsible for approving the form, term and nature of the investments of the FSB. At the discretion of the Decision-Making Council, the Union may hire the services of federal financial institutions to act as operating agents of the FSB. These services will be remunerated.

As approved by the National Congress (first by the Chamber of Deputies and then by the Federal Senate), the funds of the FSB can be formed by: (i) funds of the National Treasury, corresponding to appropriations assigned to the FSB in the annual budget, including those arising out of public debt bonds' issues; (ii) shares of federal mixed-economy companies that exceed the number which is necessary for keeping the company's control with the Union and other rights with net worth value; and (iii) earnings of financial investments made to its account. While such funds are not destined for the purpose contemplated in the law, as mentioned above, they must be deposited at the National Treasury's Sole Account. The original wording of Law 11,887/2008, as approved by the National Congress, expressly prohibited the payment of units of the FFIE with funds originated from the issue of public debt bonds, including those arising out of the return of its financial investments.

However, at the same time that the President of the Republic sanctioned Law 11,887/2008, he issued Provisional Measure (*Medida Provisória* – MP) No. 452, also dated December 24, 2008, whereby the restriction contained in the law was changed and circumvented. MP 452/2008 revoked the original prohibition and admitted that the funds of the FSB be also formed by federal public debt bonds. Furthermore, the Union was authorized to issue, at market value, in the form of direct placement in favor of the FSB, federal public debt bonds and to repay in advance such bonds also at market value. The reason to justify such MP, which is deemed to be highly questionable from a legal standpoint, was that the Federal Senate decided to approve the FSB but did not assign any appropriation to the FSB in the Union's annual budget for 2009 and therefore the effective operation of the FSB would have to be postponed for the subsequent year (2010) because there were no monetary resources available to finance it.

Based on MP 452/2008, at the end of 2008, the Union issued and placed in favor of the FSB federal public debt bonds (Brazilian treasury bonds), raising the amount of R\$ 14.2 billion, corresponding to 0.5 percent of the gross domestic product, destined to initiate the operation of the FSB in 2009. The result of the sale of these bonds will be allocated to the FFIE.

The controversy is not yet concluded because MP 452/2008 may still be rejected by the National Congress within six months of its publication<sup>7</sup>, when the lawmakers resume their duties at the start of February of 2009. Furthermore, on December 29, 2008 the opposition parties submitted an appeal to the Brazilian Federal Supreme Court (*Supremo Tribunal Federal* – STF), filing a lawsuit to call for the unconstitutionality of such MP, and now the matter will have to be examined, reviewed and decided by the Judiciary Branch. Last but not least, the Executive Branch must also have to announce the regulations of the FSB and the FFIE.

## Victory for Bankruptcy Trustee in Dutch Ponzi Scheme Case

<sup>7</sup> Both Law 11,887/2008 and MP 452/2008 were published in the Official Gazette of the Union of December 26, 2008.

In a deepening financial crisis an increase in litigation is inevitable. Several post-credit squeeze law suits have already been filed in the US, and similar actions are bound to follow in Europe.

On 12 February a ruling of the Amsterdam district court was published confirming this pattern. The case involved a Ponzi scheme (albeit significantly smaller than the Madoff case) where new investor money was used to make payments to earlier investors to create the false illusion that the investments were successful. The fraudulent investment adviser running the scheme was recently released from prison after having served 3.5 years of his 5-year sentence.

The claim of the bankruptcy trustee targeted one of the few early investors that had in fact gained much from the scheme. The trustee reclaimed millions paid out of the scheme amongst others on the basis of unjust enrichment and convinced the court that if and to the extent the defendant received returns through the scheme that did not result from investments, he had been unjustifiably enriched at the expense of the other creditors in the bankruptcy.

If the trustee is able to prove that funds from the investor involved were never invested, the defendant will be ordered to repay an amount equal to the difference between his investment in the scheme and the returns he had received through the scheme. Although the court denied all of the defendant's counterclaims, it awarded the defendant statutory interest on the amount of his contribution to the scheme. The court considered this a reasonable return on his investment. The defendant meanwhile appealed the decision of the court.

The trustee's victory seems good news for the investors who lost money through the scheme. However, independently from the Amsterdam district court case, the tax authorities have indicated that they may wish to pursue a claim to tax deemed proceeds from the Ponzi scheme against the scheme's perpetrator. If their disputed claim proves to be successful the funds available for the investors who lost their money through the scheme will be reduced substantially.

Now the bankruptcy trustee has won this round, the relative winners in alleged fictitious investment schemes may be on the hook for further lawsuits resembling the potential clawback claims by the trustee in the Madoff case.

## **Dutch financial markets regulator decides to ease securities lending disclosure obligations**

By Stibbe, Investment Management Group

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On 19 February the Dutch financial markets regulator (Autoriteit Financiële Markten or AFM) announced to relax disclosure requirements for repos and securities lending agreements. Borrowers and purchasers in repo and securities lending transactions no longer need to notify their transactions if they relend the securities before the end of the following trading day or otherwise lose title to or transfer the securities. If the securities are retained beyond the following trading day, notification is still required.

Dutch rules require disclosure when stakes pass 5%.

## Dutch financial markets regulator decides to extend short selling prohibition until 1 June 2009

By Stibbe, Investment Management Group

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On 24 February the the Dutch financial markets regulator (*Autoriteit Financiële Markten* or AFM) announced to extend its short selling prohibition until 1 June 2009. The decision follows strong support for the extension on which the AFM consulted the week before. Following other regulators around the world, the AFM in September 2008 announced short selling measures in relation to stocks in Dutch financial sector companies on an emergency basis. Disclosure of a net short position in the stock of a Dutch financial sector company will continue to be required once a position reaches 0.25% of a relevant firm's issued share capital.