IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

Waterfall II Application
No. 7942 of 2008

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR
(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED
(2) CVI GVF (LUX) MASTER S.A.R.L.
(3) HUTCHINSON INVESTORS LLC
(4) WENTWORTH SONS SUB-DEBT S.A.R.L.
(5) YORK GLOBAL FINANCE BDH, LLC
(6) GOLDMAN SACHS INTERNATIONAL

Respondents

GOLDMAN SACHS INTERNATIONAL'S POSITION PAPER

Introduction

1. This paper summarises the position of Goldman Sachs International (**"Goldman Sachs"**) in relation to the application for directions made by the **Joint Administrators** of Lehman Brothers International (Europe) (**"LBIE"**) on 12 June 2014, as amended pursuant to the Order of Mr Justice David Richards dated 9 March 2015 (the **"Waterfall II Application"**).

2. This paper sets out Goldman Sachs' position in outline in relation to Issues 11-14 and 27, as reformulated in the amended application (**"the Default Rate Issues"**). The position set out below will be developed further in submissions at the trial listed for November 2015.

3. Unless otherwise stated, this position paper adopts the definitions used in the Joint Administrators' Application Notice.

Issue 11

Is the meaning that should be given to the expression "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount" capable of including:

(1) The actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount; and / or

(2) The actual or asserted average cost to the relevant payee of raising money to fund or of funding all its assets by whatever means, including any cost of raising shareholder funding; and / or

(3) The actual or asserted cost to the relevant payee to fund or of funding and / or carrying on its balance sheet an asset and / or of any profits and / or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and / or its equity capital in light of the nature and riskiness of that asset; and / or

(4) The actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE?

Goldman Sachs' position on Issue 11

4. Goldman Sachs' position is that the expression "*cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" does not limit a relevant payee to the cost of any particular type of funding, and is capable of including the cost of any source of funding that the relevant payee did use or could have used to fund the relevant amount, subject to the obligation of the relevant payee to certify such cost rationally and in good faith. It can include, in particular, the cost of equity funding. It is not restricted to the cost of funding raised by borrowing.

5. Goldman Sachs will rely, in summary, on the following arguments:

   (1) The plain wording of the ISDA Master Agreement and definition of "Default Rate" clearly allows the non-defaulting party to certify a cost of "funding" based on any source of funding and does not limit that funding to borrowing.

   (2) In addition to the plain language of the clause, the commercial purpose of the "Default Rate" provisions provides further support for this result.

   (3) The factual background against which the ISDA Master Agreement was drafted makes it clear that the definition of "Default Rate" is intended to allow the relevant payee to certify the cost of equity funding.

6. The first two arguments include points of particular relevance to financial institutions, as well as points of more general application, and are dealt with briefly below. The third argument is based on the particular factual position of financial institutions, and this position paper therefore focuses on this argument in more depth.

<u>Wording of the ISDA Master Agreement</u>

7. The wording of the definition of Default Rate allows for the non-defaulting party to certify a cost of funding based on any source of funding:

(1) The wording of the clause draws no distinction between different types of funding. It simply refers to *"the cost ...to the relevant payee ... if it were to fund or of funding the relevant amount"*. Any interpretation of the clause that would limit a relevant payee's cost of funding to their cost of borrowing would have to: (i) read down the word "funding" to mean "ordinary unsecured borrowing", or (ii) otherwise imply into the definition words that would achieve this result. There is no basis for either in the clause.

(2) Instead, the definition makes it clear that the context and circumstances of the default and of the particular payee must be considered in assessing a party's cost of funding. The definition states expressly that it is the cost of funding *"the relevant amount"* by *"the relevant payee"* that must be certified, not an abstract notional amount. The circumstances in which the "relevant amount" came to be funded or could have been funded by the particular "relevant payee" are therefore crucial. If the non-defaulting party could have or did fund such an amount with equity then there is no good reason for preventing it from certifying its cost of funding based on the cost of that equity.

(3) Importantly, there is also nothing in the definition of "Default Rate" that would justify a different approach being taken to different types of counterparty. Following Wentworth's withdrawal of its "market usage" case, which sought to single out financial institutions for special (and prejudicial) treatment, this appears to be common ground. Different types of counterparty may draw on different types of funding source, depending on their particular circumstances: for example, as is further set out below, financial institutions use both equity and debt funding and may be required to use equity capital to fund the losses caused by an ISDA Master Agreement default. Since the definition of "Default Rate" must apply to all counterparties equally, it follows that it should not be interpreted as imposing an overly narrow "one size fits all" approach by arbitrarily restricting the non-defaulting party to one type of funding (borrowing). Rather, consistent with the wording of the definition, it should be interpreted broadly as permitting any type of "funding" to be certified.

Commercial Purpose

8. In addition to being required by the plain language of the clause, allowing parties to certify their cost of funding from any or all sources, including their cost of equity funding, is necessary to give effect to the commercial purpose of the Default Rate clause:

(1) As is stated in Wentworth's Position Paper, the purpose of the Default Rate provisions in the ISDA Master Agreement is "to compensate the person entitled to payment for having been kept out of its money", i.e. the sum that it should have been paid by the defaulting counterparty upon its default (see para. 59 of Wentworth's Position Paper and paras. 11 and 20 of its Revised Position Paper).

(2) The ISDA Master Agreement sets out a bespoke contractual scheme to achieve this purpose: if the defaulting party delays payment, then it is contractually obliged to compensate the non-defaulting party by paying to it "the cost…to the relevant payee…if it were to fund or of funding the relevant amount plus 1%".

(3) The only interpretation of the provision that gives effect to this purpose is for the non-defaulting party to be entitled to certify, subject to a duty to act rationally and in good faith, a cost of funding (whether equity or borrowing) that takes into account any type of funding used or which would have been used to fund the relevant amount. If the non-defaulting party was not entitled to certify these costs, then it would not be fully compensated for the costs imposed by it being kept out of its money and the purpose of the Default Rate provisions would be defeated.

(4) Given this purpose there would be no commercial justification for requiring that the relevant payee be compensated only by reference to the cost of debt funding, in circumstances where the non-defaulting party funded or would have funded the relevant amount by equity funding. Such an interpretation would artificially restrict the basis on which the non-defaulting party should be compensated for the cost of such funds, forcing them to certify their Default Rate based on a cost of borrowing which may be lower than their

actual cost. Such an uncommercial restriction would need to be clearly agreed if it was to apply, but there is no evidence in the ISDA Master Agreement that the draftsmen of the ISDA Master Agreement intended to limit the clause in this way.

(5) An interpretation of the definition that is limited to debt funding would also be unworkable in practice. Financial institutions always use both equity and debt funding, but there is not always a strict division between raising debt and other types of funding. For example, parties to the ISDA Master Agreement (and financial institutions in particular) issue hybrid instruments to fund the relevant amount, which may contain elements or exhibit characteristics of both debt and equity funding. There is no coherent basis for excluding such funding sources from the certification of an institution's cost of funding for the purposes of the "Default Rate" definition, on the grounds that they are not strictly "borrowing", nor is such an arbitrary approach required by the text of the clause. For the same reason, once the definition of "Default Rate" is found to not be limited solely to borrowing, there is no sensible basis on which only some (but not all) other types of funding could be included. The better view is that *any* funding source is capable of being included in the relevant payee's certification (subject to the need to act rationally and in good faith). Otherwise, definitional issues and uncertainty would abound which would not only be unsatisfactory in themselves, but would not have been intended by sophisticated commercial parties.

Factual Background: The Position of Financial Institutions

9. The factual background against which the ISDA Master Agreement was drafted and agreed is critical. This background makes it clear that the definition of "Default Rate" was intended to be broad enough to allow parties to certify a cost of funding that may include the cost of equity funding. In particular:

(1) Financial institutions are required by regulatory rules and/or the demands of financial market participants (including investors and counterparties) to maintain equity capital at all times. In particular:

(a) All financial institutions are required by law and regulation to maintain a certain amount of equity capital against their assets. These requirements are referred to as "capital ratios".[1] The various ratios may encompass different classes of capital including common equity, preferred equity and other instruments of varying degrees of subordination. Capital ratio requirements have applied to financial institutions since before the 1992 ISDA Master Agreement was first drafted and at all material times since.

(b) This regulatory framework specifically mandates that these institutions must hold a certain amount of equity capital against assets funded on the balance sheet. As the balance sheet of a bank grows, or contracts due to losses, the cushion of loss absorbing equity must adjust accordingly. An assumption that assets can be funded with debt alone would run directly contrary to the regulatory framework and would fail to capture the cost of funding. While financial institutions are subject to a specific regulatory framework, it should be noted that this framework mandates a practice that is common across all corporations, namely to ensure that there is sufficient equity to absorb losses and protect against default on debt. As additional assets are funded, or losses are incurred, it is appropriate, and in the case of financial institutions required, that additional equity is used such that the proportion of equity in the funding mix (both on an asset-risk-adjusted and absolute basis) remains at a prudent level.

(c) The requirement of equity funding is even more significant in the case of a default which causes a financial institution to incur a loss. In that scenario the loss would reduce the reported equity capital and regulatory capital ratios and increase the leverage ratio reported to investors. In order for a financial institution to rectify this loss and return its regulatory capital ratios to the previous level, it would be required to use new equity to cover the full amount of the loss. Financial institutions may be required to do this for business

[1] Appendix, Section B. See also the summary at paras. 35-47 of the Waterfall I Application judgment, at [2014] EWHC 704 (Ch).

reasons (including responding to the demand of other market participants) even if the default itself did not force the bank below its regulatory minimum.

(d) Thus, even where regulations do not require the financial institution to increase equity capital at the particular time, the institution may seek to do so for reasons of prudence and sound business judgment in light of the demands of other market participants. In particular:

(i) A financial institution may be required to maintain a certain amount of equity capital, given its perception of market demands, in order to ensure that other market participants maintain confidence in that institution as a business and credit worthy counterparty.[2] If a financial institution is seeking to maintain or improve its capital ratios from current levels (as might reasonably have been anticipated by the draftsman of and parties to the ISDA Master Agreement, when considering the likely market circumstances that would accompany the default of a counterparty to that financial institution), and it sustains losses, it may need to raise new equity in order to maintain the confidence of its regulators and market participants (including the counterparties/clients with which it transacts, investors and rating agencies).

(ii) This is all the more so where a default occurs at a time when financial institutions are in a deleveraging cycle (i.e. raising the equity component of its capital profile) such as was the case in September 2008. In such a market a loss could not be funded using borrowing, as to do so would increase the financial institution's leverage at a time when the institution, its investors and regulators were seeking the reverse. Indeed, the market experienced by financial institutions in 2008, at and around the time of Lehman Brothers' collapse, provides a clear example of circumstances in which regulators and participants in the

[2] Appendix, Section C.

capital markets demanded that financial institutions raise further equity capital to fund any losses and to deleverage their capital ratios.[3]

(iii) Further, by increasing its equity capital position in such circumstances a financial institution could then be able to avoid later regulatory and/or market requirements to raise equity capital at a potentially less attractive time or on less attractive terms.

(2) Financial institutions were responsible for the formation of ISDA and were instrumental in the original process by which the 1992 form and the 2002 form were drafted.[4] They have always been among the principal classes of counterparties using the form. This heavy participation of financial institutions would have been very much in the draftsmen's mind during the preparation of the ISDA Master Agreement.

(3) The factual background set out above is therefore highly relevant in construing the ISDA Master Agreement, since it forms a key part of the factual matrix against which the definition of "Default Rate" must be interpreted. In particular:

(a) It would have been reasonably anticipated by parties entering into ISDA Master Agreements, at all material times, that a financial institution counterparty would use various types of funding, including equity, to fund the "relevant amount", or be required to do so.

(b) It is inconceivable that the parties negotiating the ISDA Master Agreement would have intended that financial institutions, for the purpose of certifying the cost of their funding under that Agreement, should be compelled to ignore this key aspect of the way in which they fund themselves. If financial institutions were not permitted to include cost of equity in their certification this would arbitrarily limit them to certifying a cost of funding (borrowing) which they may not have used

[3] Appendix, Section C.

[4] Appendix, Section A.

at all (and potentially could not have used) or only used in part. This would leave them bearing a substantial amount of the funding costs imposed upon them by the non-payment of the defaulting party, rather than being able to pass such costs on (as was clearly the intention of the Default Rate provisions) to the defaulting party. There is no good reason why the draftsman would have intended to restrict financial institutions to the cost of one type of funding (borrowing) in this way, when the reality for financial institutions might (and likely would) involve access to other funding sources.

(c) The definition of "Default Rate" plainly was intended to avoid this result. As is set out above, the purpose and wording of the "Default Rate" provisions support an interpretation that would permit a broad and flexible approach to the certification of costs of funding. The particular requirements of financial institutions and their reliance on various sources of funding also make it clear that this is the correct interpretation.

10. On this basis Goldman Sachs' position on the specific questions raised by Issue 11 is that the expression "*cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" is capable of including each of the heads of cost set out therein:

(1) It may include the cost to the payee to fund or of funding the relevant amount by borrowing.

(2) It may include (and in the case of financial institutions, it is vital that it does include) any actual or asserted cost of funding the relevant amount by whatever means, including by shareholder (i.e. equity) funding.

(3) It may include:

(a) The costs to the payee of raising equity capital to fund the loss caused by the default. As is noted above, this loss will impact directly upon a financial institution's equity capital. A financial institution may therefore be required to use replacement equity capital to fund this loss.

(b) The cost, including the cost of equity, of funding the residual defaulted claim (here a trade claim for the LBIE receivable that had been lost as a result of LBIE's default) on its balance sheet.

(c) Any impact on the payee's cost of borrowing and/or equity arising from the nature and riskiness of that claim.

(4) Goldman Sachs does not, at present adopt a position on Issue 11(4), which does not appear (at least as regards the position of financial institutions) to add materially to Issues 11(1) to (3).

Issue 12

If and to the extent that the "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund...the relevant amount" includes a cost of borrowing:

(1) Should such borrowing be assumed to have recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets?

(2) If the latter, should the cost of funding include the incremental cost to the relevant payee of incurring additional debt against its existing asset base or should it include the weighted average cost on all of its borrowings?

(3) Should such cost include any impact on the cost of the relevant payee's equity capital attributable to such borrowing?

(4) Is the cost to be calculated based on obtaining:

(i) overnight funding; or

(ii) term funding to match the duration of the claim to be funded; or

(iii) funding for some other duration?

Goldman Sachs' position on Issue 12

11. As is set out above, Goldman Sachs' position is that the relevant "cost" may include any funding which the non-defaulting party may draw upon, which may include (but is not limited to) its cost of any type of borrowing. A non-defaulting party (whether financial institution or otherwise) may rely on its own sources and duration of funding, and the definition of Default Rate permits it to certify its own individual cost which will be a function of the particular facts and circumstances applicable to that payee (subject to the duty to act rationally and in good faith).

12. As regards the specific questions raised under Issue 12:

    (1) Funding raised by a relevant payee, i.e. the non-defaulting party, should not be assumed to have recourse solely to the relevant payee's claim against LBIE. It may be assumed to have recourse to the rest of the relevant payee's unencumbered assets.

    (2) A non-defaulting party may certify a cost of funding (including a cost of borrowing) based on the incremental cost of incurring additional funding (including debt). However, should that additional funding affect the weighted average cost of all the payee's funding (including, though not only, through raising overall its cost of borrowing), this effect can be taken into account in certifying the payee's overall cost of funding.

    (3) A non-defaulting party may take into account the effect on its cost of equity capital attributable to the raising of further funds (including borrowing). Raising funding that is senior to equity capital can tend to increase the costs of equity funding, as a result of the increase in the payee's leverage.

    (4) A non-defaulting party may certify its cost of funding on any basis that it did adopt or could have adopted. This may include overnight funding, longer duration funding, or funding to match the duration of the claim to be funded, and there is no basis in the ISDA Master Agreement for limiting the basis on which the cost is calculated.

Issue 13

Whether the "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount" should be calculated:

(i) by reference to the relevant payee's circumstances on a particular date; or

(ii) on a fluctuating basis taking into account any changes in the relevant circumstances (and if so, whether the benefit of hindsight applies when taking into account such changes),

in each case, whether or not taking into account relevant market conditions.

Goldman Sachs' position on Issue 13

13. A payee may certify its cost of funding on any basis that it rationally and in good faith did adopt or could have adopted. The certification would usually be given at the end of the period to which it relates.

14. The definition of "Default Rate" is permissive, and the non-defaulting party may certify a cost of funding calculated on any basis that (acting rationally and in good faith) it did adopt or could have adopted. This may include a calculation by reference to the payee's circumstances on a particular date. For example, if the payee did anticipate or could have anticipated at a particular date that the relevant amount would not be paid for some time, or if short-term funding was not readily available at that time, then it would be possible for that payee to certify a cost of funding on the basis that the relevant payee did use or would have used long duration funding to fund the relevant amount.

15. The cost may also be calculated taking into account changes in the circumstances of the payee over time. The calculation should be made by reference to what the payee did decide to do or could have decided to do at the relevant time at which the funding would have been taken out. The relevant payee should not be assumed to have known how the market would develop in the future at the time(s) when it would have had to decide on the type of funding to adopt.

16. In any case, relevant market conditions at the applicable time may be taken into account in conducting the calculations, to the extent that those conditions were or could have been taken into account by the payee (acting rationally and in good faith) in obtaining funding.

Issue 14

Whether a relevant payee's certification of its cost of funding for the purposes of applying the "Default Rate" is conclusive and, if not, to what it is subject. In particular whether, in order for a payee's certification to be deemed conclusive, a relevant creditor is under any duty to act:

(i) reasonably;

(ii) in good faith and not capriciously or irrationally; or

(iii) otherwise than in its own interests.

Goldman Sachs' position on Issue 14

17. Provided a relevant payee's certification of its cost of funding is made rationally and in good faith (in the sense in which those terms are used in *Socimer International Bank Ltd v. Standard Bank of London Ltd* [2008] EWCA Civ 116; [2008] 1 Lloyd's Rep 558) it will be conclusive.

Issue 27

Whether, and if so how, the answers to questions 10 to 26 would be impacted where the "relevant payee" is:

(i) A Credit Institution or Financial Institution;

(ii) A Fund Entity; or

(iii) A corporate or other type of counterparty.

Goldman Sachs' position on Issue 27

18. The definition of Default Rate applies in the same way to all types of counterparty to the ISDA Master Agreement, irrespective of whether they are a credit institution or financial institution, or fund entity, or corporate or other type of counterparty. As noted above this now appears to be common ground, and there is nothing in the language of the ISDA Master Agreement to suggest otherwise.

MARK HOWARD QC

CRAIG MORRISON

23 July 2015

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APPENDIX TO GOLDMAN SACHS INTERNATIONAL'S POSITION PAPER

A. THE ROLE OF FINANCIAL INSTITUTIONS AND THE ISDA MASTER AGREEMENT

1. Financial institutions have always been among the primary participants in over-the-counter (OTC) derivatives transactions. They played a key role in the formation of ISDA and the drafting of the ISDA Master Agreements.

2. As the market for these derivatives developed in the 1980s and the number of transactions increased, there were attempts to standardise derivatives documentation. These were led by financial institutions and their trade associations. In the UK these included the publication in 1985 by the British Bankers Association of three sets of standard terms for use in the London inter-bank market.[1]

3. At around the same time in the US, a group of financial institutions formed a committee to discuss standardisation of derivatives documentation. This committee evolved into ISDA, which was established in March 1985 (initially as the "International Swap Dealers Association", later renaming itself the "International Swaps and Derivatives Association"). ISDA's founding members were financial institutions: Bankers Trust Company, Citibank N.A., The First Boston Corporation, Goldman, Sachs & Co., Kleinwort Benson Cross Financing Inc, Merrill Lynch & Co Inc, Morgan Guaranty Trust Company of New York, Morgan Stanley & Co Inc, Salomon Brothers Inc and Shearson Lehman Brothers Inc.[2]

4. ISDA published a Code of Standard Wording, Assumptions and Provisions for Swaps in June 1985. This was followed, in 1987, by the ISDA Interest Rate and Currency Exchange Agreement (the "**1987 ISDA Master Agreement**"). The 1987 ISDA Master Agreement has been described as "*groundbreaking*" and as representing "*a consensus between the leading swap dealers about the terms that they would expect to see in a document of this type*".[3]

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[1] Firth, *Derivatives Law and Practice*, Release 27 (May 2015), 10.002.

[2] *Ibid.*

[3] Firth, 10.004.

5. In 1991 the Board of Directors of ISDA commenced a project to revise the 1987 Master Agreement and related documentation, which led to the publication of the 1992 ISDA Master Agreement (the "**1992 ISDA Master Agreement**").[4]

6. According to the 1992 ISDA Master Agreement User Guide, the main objectives in revising the 1987 ISDA Master Agreement were to: "*(i) expand the ISDA documentation architecture to facilitate inclusion of derivative products in addition to those products originally contemplated by earlier generations of ISDA documentation and thereby promote the benefits of cross-product netting, (ii) address legal developments since 1987 (e.g., 1990 amendments to the U.S. Bankruptcy Code) and (iii) incorporate modifications and clarifications deemed important based on experience gained since 1987 and form a consensus of the ISDA membership on such modifications and clarifications*".[5]

7. The derivatives market has grown significantly since both the 1987 Master Agreement and the 1992 ISDA Master Agreement were published: ISDA statistics show that at the end of 1987 there were notional amounts of US$866bn outstanding under interest rate and currency trades. By the end of 1992 that figure was US$5,346bn and by the end of 2008 it was US$403,073bn.[6]

8. Other types of institution have joined ISDA during this period, but financial institutions remain strongly represented among ISDA members. Of the 863 ISDA members listed on the ISDA website in 2015, 208 are "primary members", representing "*An investment, merchant or commercial bank or other corporation, partnership or other business organization that deals in derivatives as part of its business*". This includes Goldman, Sachs & Co., of which Goldman Sachs International is an affiliate. Hedge funds, corporates, insurers, central banks, pension funds and other such entities are among the 369 "subscriber members", representing "*corporations, financial institutions and government entities and others who use*

[4] ISDA, *User's Guide to the 1992 ISDA Master Agreements*, 1993 edition, p. i.

[5] *Ibid.*

[6] http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf (accessed on 23 July 2015).

privately negotiated derivatives to better manage financial risks". The remaining 286 members are "associate members" such as law firms and other service providers.[7]

B. REGULATORY CAPITAL ADEQUACY REQUIREMENTS APPLICABLE TO FINANCIAL INSTITUTIONS

9. Financial institutions have been subject to regulations imposing capital requirements since well before the publication of the 1992 ISDA Master Agreement, and at all times thereafter. These regulations require them to hold a certain amount of capital, including equity capital.

10. Fuller details can be provided to the extent it would assist the Court, but the following examples provide illustrations of these requirements at various times:

    (1) Regulatory capital requirements have been a feature of the UK financial system for many years. For example, the Banking Act 1979 imposed a requirement on deposit takers to maintain certain levels of "*net assets*", meaning "*paid-up capital and reserves*".[8]

    (2) In the US, specific capital standards were first imposed in 1981. This occurred, as described by the Federal Reserve, "*following a period in which already low capital ratios at large U.S. banks continued to decline in the face of a substantial deterioration in the quality of loan portfolios due primarily to exposures to emerging economies*".[9]

    (3) The first Basel Accord, Basel I, was published in July 1988.[10] Basel I required an institution to hold a certain amount of capital against its risk weighted assets including derivative exposures. The UK implemented these

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[7] http://www2.isda.org/membership/member-types (accessed on 23 July 2015).

[8] Banking Act 1979, Schedule 2(5). A similar requirement was imposed by Schedule 3(6)(1) of the Banking Act 1987.

[9] Federal Reserve, *Federal Reserve Bulletin*, September 2003, p. 395, http://www.federalreserve.gov/pubs/bulletin/2003/0903lead.pdf (accessed on 23 July 2015).

[10] Basel Committee on Banking Supervision, *International convergence of capital measurement and capital standards*, July 1988.

requirements from the end of 1989[11] and they were therefore in force when the 1992 ISDA Master Agreement was being drafted.

(4) Basel I was subsequently replaced by Basel II.[12] In short summary, the Basel II rules in place in the UK in 2008 required financial institutions to (inter alia) meet a number of capital ratios, including the tier 1 common equity ratio (i.e. the ratio of the institution's common equity to risk weighted assets), the tier 1 capital ratio (which also included preferred equity) and the tier 1 total capital ratio (which additionally included some forms of subordinated debt).[13] Ordinary unsecured borrowing did not count towards any of these capital ratios.

(5) Basel II is itself being replaced by the requirements of Basel III, which similarly require financial institutions to meet various capital ratios.[14]

11. In addition to the minimum regulatory requirements, the amount of equity capital that any individual bank is required to hold is, in practice, subject to discussion between the bank and its regulators.

C. MARKET CAPITAL ADEQUACY REQUIREMENTS APPLICABLE TO FINANCIAL INSTITUTIONS

12. In addition to the regulatory rules set out above, financial institutions fund themselves with equity and other forms of regulatory capital to the level demanded by the market, including counterparties, investors and rating agencies. A failure to do so can limit a financial institution's ability to do business as a creditworthy counterparty and to access funding, including further borrowing and equity investment. It may therefore

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[11] Bank of England, *Banking Act Report for 1989/90*, p. 18, http://www.bankofengland.co.uk/archive/Documents/historicpubs/bar/bar8990.pdf (accessed on 23 July 2015).

[12] Basel Committee on Banking Supervision, *International convergence of capital measurement and capital standards – a revised framework*, June 2004.

[13] Detailed rules in this regard were set out in the Financial Services Authority's GENPRU and BIPRU Sourcebooks, and are referenced at paras. 35-47 of the Waterfall I Application judgment, at [2014] EWHC 704 (Ch)

[14] Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (rev June 2011).

be necessary or prudent for financial institutions to raise further equity capital in certain circumstances.

13. The financial crisis in and around Lehman's default in September 2008 provides a clear example of a situation where Financial Institutions may have needed to raise additional equity capital as a result of demands from both regulators and other market participants:

(1) A number of global financial institutions had encountered severe financial difficulties after the financial crisis and "credit crunch" began in summer 2007. During this period concerns grew about the strength of a number of financial institutions, which resulted in them encountering significant difficulties in accessing sufficient funding;

(2) In late 2008/early 2009, as a result of the financial crisis, most major financial institutions were raising equity capital and seeking to deleverage.[15] This was necessary in order to replace the losses to equity caused by defaults, including the Lehman defaults. Furthermore, in the market of 2008-2009 financial institutions were seeking to deleverage more generally, as a result of pressure from regulators and market participants and for reasons of prudence. They therefore raised significant equity capital at this time to fund losses.[16] They funded such losses to equity capital not by raising additional debt, which would have *increased* their leverage, but by raising further equity.

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[15] This is evident from numerous public sources, including, for example, the table of capital placements compiled by Bloomberg in late September 2008: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSlW.imTKzY8 (accessed on 23 July 2015).

[16] Increases in the amount of capital held by banks and the steps taken by financial institutions to deleverage are also evident from numerous public sources, including:

Federal Reserve, *Comprehensive Capital Analysis Review 2015*, March 2015, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20150311a1.pdf (accessed on 23 July 2015), and Forbes, *A Look at Common Equity Tier 1 Ratios for the Largest US Banks,* 6 March 2015, http://www.forbes.com/sites/greatspeculations/2015/03/06/a-look-at-common-equity-tier-1-capital-ratios-for-the-largest-u-s-banks/ (accessed on 23 July 2015);

Data from the St. Louis Federal Reserve setting out "Total Equity to Total Assets for Banks" over the relevant period: https://research.stlouisfed.org/fred2/series/EQTA (accessed on 23 July 2015);

BIS Quarterly Review, *How have banks adjusted to higher capital requirements?*, September 2013: http://www.bis.org/publ/qtrpdf/r_qt1309e.pdf (accessed on 23 July 2015).

(3) The following table illustrates some examples of financial institutions that raised equity capital during this period:

Date	Capital Raised	Amount Raised	Source (all accessed on 23 July 2015)
Bank of America			
7 October 2008	Common stock issued in an underwritten public offering	US$ 10bn	http://www.sec.gov/Archives/edgar/data/70858/000089552708000101/bofacommonstock8k1.htm
20 May 2009	Sale of common stock through an At-the-Market issuance program	US$ 13.5bn	http://www.sec.gov/Archives/edgar/data/70858/000119312509115340/dex991.htm
Citigroup			
16 January 2009	Perpetual preferred stock issued to the Federal Deposit Insurance Company	US$ 10bn	http://www.sec.gov/Archives/edgar/data/831001/000095010309000098/dp12291_8k.htm
Morgan Stanley			
14 October 2008	Perpetual non-cumulative convertible preferred stock and perpetual non-cumulative non-convertible preferred stock issued to Mitsubishi UFJ Financial Group	US$ 9bn	http://www.sec.gov/Archives/edgar/data/895421/000089882208001004/pressrelease.htm
Barclays			
18 September 2008	Common stock	GBP 0.7bn	http://www.sec.gov/Archives/edgar/data/312069/000119312509061865/d6k.htm
31 October 2008	Reserve Capital Instruments and Mandatorily Convertible Notes issued to Qatar Holding, Challenger Universal and entities representing the beneficial interests of HH Sheikh Mansour Bin Zayed Al Nahyan	GBP 7.3bn	http://www.sec.gov/Archives/edgar/data/312069/000119312508221197/dex991.htm
Goldman Sachs			
24 September 2008	Perpetual preferred stock issued to Berkshire Hathaway	US$ 5bn	http://www.sec.gov/Archives/edgar/data/886982/000095012308011720/y71480exv3w1.htm
24 September 2008	Common equity raised in a public offering.	US$ 5bn	http://www.sec.gov/Archives/edgar/data/886982/000095012308011720/y71480exv3w1.htm

Date	Capital Raised	Amount Raised	Source (all accessed on 23 July 2015)
14 April 2009	Common stock issued via a public offering	US$ 5.8bn	http://www.sec.gov/Archives/edgar/data/886982/000095012309006462/y76111exv99w1.htm
JPMorgan			
30 September 2008	Common stock	US$ 11.5bn	http://www.sec.gov/Archives/edgar/data/19617/000095012308014621/y72204e10vq.htm#120
1 June 2009	Common equity	US$ 5bn	http://www.sec.gov/Archives/edgar/data/19617/000119312509122723/dex991.htm

Waterfall II Application

No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR

(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED
(2) CVI GVF (LUX) MASTER S.A.R.L
(3) HUTCHINSON INVESTORS, LLC
(4) WENTWORTH SONS SUB-DEBT S.A.R.L
(5) YORK GLOBAL FINANCE BDH, LLC
(6) GOLDMAN SACHS INTERNATIONAL

Respondents

GOLDMAN SACHS INTERNATIONAL'S POSITION PAPER

Cleary Gottlieb Steen & Hamilton LLP
City Place House
55 Basinghall Street
London EC2V 5EH

Tel: 020 7614 2200
Fax: 020 7600 1698
Ref: JK/JB/80277-022

Solicitors for the Sixth Respondent