

Lehman Brothers International (Europe) (in administration) (“LBIE”) Unsettled trades – Market Update

Background

This Update follows on from the statement issued on 8 October 2008 by Joint Administrators (the “**Administrators**”) on LBIE’s behalf concerning the possibility of cancelling unsettled securities trades. The purpose of this Update is to update LBIE’s clients and counterparties on the approach proposed by the Administrators for dealing with LBIE’s unsettled securities trades which were due to settle across the various markets and settlement systems set out below (the “**Cancellation Proposal**”). In all instances, the Cancellation Proposal is intended to address two areas of market uncertainty, the first being the process for removing settlement instructions from the relevant settlement systems and the second being the cancellation and, where relevant, cash settlement of the underlying trades between LBIE and each of its clients and counterparties.

As of the appointment of the Administrators on 15 September 2008 (the “**Administration Date**”), it has been estimated that there were approximately 142,000 unsettled securities trades to which LBIE is a counterparty, of which approximately 83,500 were trades to be settled in Europe, 45,000 in Asia and 12,500 in the US. Of the 83,500 unsettled cash trades in Europe, a small number of these were executed on an exchange, often involving a central counterparty. The majority of these trades were executed off exchange, but were to be settled through a settlement system. Of the 83,500 unsettled cash trades in Europe, approximately 65% were to be settled through the settlement systems in the following markets: Euroclear (ICSD), Denmark, France, Italy, Norway, Switzerland and the UK.

With respect to the unsettled trades in the US, historically LBIE relied on Lehman Brothers Inc (“**LBI**”) to execute and settle trades on behalf of its clients. Accordingly, the Administrators are interacting with LBI to resolve LBIE’s unsettled trades in the US. In the Asian markets, LBIE used other affiliates (principally Lehman Brothers Japan Inc (“**LBJ**”)) and third party brokers to execute and settle trades. The Administrators wish to inform interested parties that they will provide a separate update on their progress in the Asian and US markets in due course and hence this update focuses on unsettled trades in European markets.

Contracts - default rules

A large number of the unsettled trades were subject to a legally binding default process that governed how LBIE’s and its counterparty’s unsettled obligations were to be dealt with. Examples of those processes are the default rules of a central counterparty, the default rules of an Exchange, and the close-out processes under applicable bilateral master agreements (such as the GMRA, ISDA, OSLA, etc.) entered into between LBIE and its counterparties.

In relation to the default processes of a central counterparty or an exchange:

- for exchange trades, the process will result or has resulted in the relevant exchange converting the respective obligations of LBIE and the counterparty (as appropriate) into a single net cash sum payable by one party to the other in respect of all contracts subject to the default process in question.
- for trades that cleared through a central counterparty, the process will result or has resulted in the relevant central counterparty converting LBIE's obligations into a single net cash sum payable either from the central counterparty to LBIE or from LBIE to the central counterparty .
- in other cases, the process required settlement of trades by LBIE or its settlement agent which either resulted in the settlement of all outstanding trades, or in the settlement of some outstanding trades only. Where a trade was settled under the relevant default process after the Administration Date, that trade does not require further action under this Cancellation Proposal.

OTC contracts - no default rules

Other trades between LBIE and counterparties fall outside any such default arrangement. Such trades are referred to here as “**OTC contracts**”, though that term excludes in this context trades executed off exchange but subject to a binding master agreement with default arrangements as described above. That therefore could cover pure cash equities trades, or fixed income trades executed off exchange and subject only to standard terms of business. As a result, there is potential uncertainty as to the legal obligations, and possible rights and liabilities, associated with those contracts, and how any related settlement instructions in a settlement system should be dealt with. The Administrators believe it would be beneficial for a process to be established with counterparties which would facilitate the removal of that uncertainty.

Deletion of settlement instructions in settlement systems

The majority of the unsettled trades to which LBIE is a counterparty were subject to settlement instructions in the settlement system where each unsettled trade was due to settle. In a number of cases, those settlement instructions are still pending in the settlement system and this needs to be resolved. For example, in many settlement systems, LBIE's and its counterparties' settlement instructions became irrevocable at a particular point in the settlement cycle – sometimes this was at the point of matching the instructions with those of the counterparty, and sometimes it was later in the settlement cycle - which means that the parties cannot now cancel their instructions except to the extent that the rules of the relevant system permit otherwise. However, in some settlement systems, an instruction (even if matched) will be automatically cancelled by the system itself if it cannot be successfully executed, normally after a specified number of days after the original settlement date.

As mentioned above, the Administrators recognise the operational uncertainty resulting from the settlement instructions that remain in the settlement systems and are in the process of determining the action that needs to be taken to resolve

this. The Administrators intend to report back on the action they propose to take on a market by market basis through these periodic Updates. The position has been set out below for a number of markets.

For clarification, the cancellation of a settlement instruction does not have the effect of cancelling the underlying contractual obligations between the parties on each unsettled trade, which remains to be resolved between LBIE and the counterparty.

Denmark (VP)

LBIE's access to the Danish settlement system ("**VP**") is through a settlement agent. All settlement instructions entered into VP by LBIE and its counterparties were subject to an expiry date after which the settlement instructions should have been automatically removed from VP if settlement had not occurred. The Administrators understand that the expiry date is usually set as 20 days after the due date of settlement. Settlement instructions on all LBIE unsettled trades should therefore have now been automatically deleted from VP.

Accordingly, no further action should be required to be taken by either LBIE or its counterparties in relation to the settlement instructions for trades in the Danish market which were due to be settled in VP. The Administrators are working with LBIE's settlement agent in Denmark to confirm this position. However, the underlying trades will need to be dealt with by LBIE and each counterparty in the manner described below.

France (Euroclear France)

LBIE has both direct access to the French settlement system ("**Euroclear France**") and also has access through a settlement agent. Settlement instructions entered into Euroclear France by LBIE and its counterparty were subject to a recycling period beginning after the due settlement date, after which those settlement instructions were automatically deleted from the system. It has now been confirmed to LBIE that all settlement instructions on LBIE's unsettled trades in Euroclear France have been removed from the system.

Accordingly, no further action is required to be taken by either LBIE or its counterparties in relation to the settlement instructions for trades in the French market which were due to be settled in Euroclear France. However, the underlying trades will need to be dealt with by LBIE and each counterparty in the manner described below.

Italy (Monte Titoli)

LBIE's access to the Italian settlement system ("**Monte Titoli**") is through a settlement agent. All settlement instructions entered into Monte Titoli by LBIE and its counterparty were subject to a validity date which was set after the due settlement date of each trade. Upon the failure of each trade to settle within the system, the settlement instructions should be automatically deleted from the

system within three days of such validity date. Settlement instructions on all LBIE unsettled trades should therefore have now been automatically deleted from Monte Titoli.

Accordingly, no further action should be required to be taken by either LBIE or its counterparties in relation to settlement instructions for trades in the Italian market which were due to be settled in Monte Titoli. The Administrators are working with LBIE's settlement agent in Italy to confirm this position. However, the underlying trades will need to be dealt with by LBIE and each counterparty in the manner described below.

Norway (VPO)

LBIE's access to the Norwegian settlement system ("**VPO**") is through a settlement agent. The Administrators understand that LBIE's counterparties may have been entitled to delete their settlement instructions from the system on a unilateral basis. Where that has happened, LBIE's settlement instructions have also been removed from VPO. It has been confirmed to LBIE that the settlement instructions on all LBIE unsettled trades have now been removed from VPO.

Accordingly, no further action is required to be taken by either LBIE or its counterparties in relation to settlement instructions for trades in the Norwegian market which were due to be settled in VPO. However, the underlying trades will need to be dealt with by LBIE and each counterparty in the manner described below.

Euroclear (International Central Securities Depository)

LBIE had a large number of outstanding settlement instructions in the Euroclear international central securities depository ("**Euroclear Bank**"). The majority of these settlement instructions were for internal settlement (in other words, settlement between a LBIE Euroclear Bank account and a counterparty Euroclear Bank account), although a number of the settlement instructions were for bridge settlement (in other words, settlement between a LBIE Euroclear Bank account and a counterparty Clearstream account) and external settlement (ie settlement between a LBIE Euroclear Bank account and a counterparty account in a local settlement system).

As at the Administration Date, these settlement instructions were at different points in the settlement cycle, either pending, matched or within the processing cycle to be matched. The procedure for cancelling these different sets of settlement instructions necessarily varies.

The Administrators are working with Euroclear Bank to resolve the outstanding settlement instructions in the system and will be able to announce a further update on this shortly.

Switzerland (SIS SegalInterSettle AG)

LBIE access to the Swiss settlement system (“**SIS Segal**”) is through a settlement agent. Settlement instructions on unsettled LBIE trades that are matched in SIS Segal can only be cancelled from the system if both parties delete their settlement instructions.

Accordingly, in order to deal with the settlement instructions remaining in SIS Segal, both LBIE and its counterparty to each unsettled trade will need to delete their settlement instructions respectively. Please see below for further detail on the Cancellation Proposal which covers bilateral cancellation of both the settlement instructions and the underlying trade.

UK (CREST)

As the Administrators have previously reported, LBIE had a large number of outstanding settlement instructions in CREST. Those settlement instructions could only be deleted from CREST on a bilateral basis, with both LBIE and each of its counterparties on all trades which were due to settle in CREST required to enter match delete instructions into the system. To assist in that process, Euroclear UK & Ireland (“**EUI**”) as the operator of CREST, directed all market counterparties (including LBIE) with outstanding settlement instructions on all LBIE unsettled trades, to input instructions in the CREST system to match delete those instructions.

The Administrators wish to inform market counterparties that LBIE complied with EUI’s directions and entered match delete instructions for all unsettled trades into CREST prior to the specified deadline of 24 October 2008.

As previously reported, the deletion of settlement instructions in CREST has no impact on the underlying trades between LBIE and each of its counterparties. Accordingly such underlying trades will need to be dealt with in the manner described below.

Proposal for bilateral cancellation and agreed net settlement of underlying trades

In order to deal with the contractual rights and liabilities associated with OTC contracts, the Cancellation Proposal is for LBIE and each counterparty to agree bilaterally that their respective liabilities under their OTC contracts would be cancelled and replaced by a determination of a net position between LBIE and the counterparty. The net position of each trade would be calculated by comparing the original trade price and its close-out price as at the close of business on the settlement date for that trade (or at some other date agreed between the parties). Note that, as the purpose of adopting this approach is to provide legal certainty and a single net position in respect of all relevant liabilities, it will be a condition of the Cancellation Proposal that all unsettled OTC contracts between LBIE and a counterparty be included in the arrangements.

For OTC contracts that were to be settled through a settlement system, where the associated settlement instructions remain outstanding in the system, the Cancellation Proposal will also be subject to the condition that the settlement instructions are first duly deleted in accordance with the rules of the relevant system.

The Cancellation Proposal is, of course, subject to the applicable laws applying to each unsettled trade and the right of a party to that trade to treat the contract as terminated. The Administrators would remind LBIE's clients and counterparties that it is their responsibility to investigate when a particular trade may be terminated under the law applying to that trade. The Administrators will deal with a client's or counterparty's assertion that a trade has been so terminated on a case-by-case basis.

Payment of the net sum

Where the calculated net position is an amount due to LBIE, this would be payable by the counterparty, subject to any pre-existing rights of the counterparty. Where the calculated net position is an amount due from LBIE, it will represent a claim on the LBIE estate and the counterparty will rank as an unsecured creditor. The Administrators wish to make clear that under no circumstances will a net position payable by LBIE rank as an expense of LBIE's administration.

Operational costs

In order to justify adopting the Cancellation Proposal, which will involve a prioritisation of LBIE's resources to calculate the relevant net sum, the Administrators need to be able to recover the costs from counterparties adopting this approach. LBIE would therefore propose to charge a fee equal to 10 basis points multiplied by the notional value of the cancelled trades with the counterparty in question, which it believes to be a reasonable proxy for the operational costs in question.

Indemnity

The Administrators will ask counterparties to indemnify them from the risk that the Cancellation Proposal is subsequently held to be invalid, or involves the giving of a preference to any creditors. That indemnity will be contained in a cancellation agreement in the following form:

"1. In the event that any person successfully claims that the cancellation, deletion or any other analogous process to unwind a trade or proposed trade contravenes or breaches any applicable law or regulation (including, without limitation, the rules of the [insert reference to relevant settlement system] or of any exchange or the Financial Markets and Insolvency (Settlement Finality) Regulations 1999), or this Agreement is otherwise deemed to be of no effect, the Parties agree to use all reasonable endeavours to reinstitute the trade or proposed trade.

2. If, and to the extent that, following the exercise of reasonable endeavours by the Parties to reinstitute the trade or proposed trade, LBIE or the Administrators, their representatives and agents suffer any losses, expenses, claims, damages and liabilities, whatsoever and howsoever occurring, directly or indirectly arising as a result of or in connection with:

i. any claim by any person that LBIE or the Administrators were not entitled to enter into and perform this Agreement or that this Agreement, the cancellation, deletion or any other analogous process to unwind a trade or proposed trade contravenes or breaches any applicable law or regulation (including, without limitation, the rules of [insert reference to relevant settlement system] or of any exchange or the Financial Markets and Insolvency (Settlement Finality) Regulations 1999); or

ii. this Agreement otherwise being held to be of no legal effect, (any such loss pursuant to sub-clause (i) or (ii) being a “**Relevant Loss**”),

the Counterparty hereby agrees to indemnify, on demand, LBIE and the Administrators, their representatives and agents in respect of the Relevant Loss.

The Terms used in this indemnity are defined in the cancellation agreement as follows:

"**Administrators**" means Anthony Lomas, Steven Pearson, Michael Jervis and Daniel Schwarzmann of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT;

"**Agreement**" means the Cancellation and Cash Settlement Agreement;

"**[insert relevant settlement system]**" means [insert definition of relevant settlement system]; and

"**LBIE**" means Lehman Brothers International (Europe) (in administration) of 25 Bank Street, London E14 5LE, with company number 02538254."

Next Steps

Any counterparty interested in discussing this approach should make contact by sending an email to: unsettledtrades.lehmanbrothers@uk.pwc.com .

The Administrators intend to prioritise each counterparty in accordance with the order of approach.

Further details relating to the administration are included on the PwC website at www.pwc.co.uk.

Notes to Editors:

AV Lomas, SA Pearson, DY Schwarzmam and MJA Jervis were appointed as Joint Administrators of Lehman Brothers International (Europe) on 15 September 2008 to manage its affairs, business and property as agents without personal liability. AV Lomas, SA Pearson, DY Schwarzmam and MJA Jervis are licensed to act as insolvency practitioners by the Institute of Chartered Accountants in England and Wales.