

Bankruptcy Law and the Capital Market: An Assessment

The Egypt Capital Markets Development Project



CHEMONICS INTERNATIONAL INC



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BANKRUPTCY LAW AND THE CAPITAL MARKET: AN ASSESSMENT

A. Purpose of the Assessment

This assessment report, and the workshop held on March 29, 2000 with industry representatives (see Appendix 1), were designed to identify provisions in Egyptian bankruptcy law that conflict with capital market laws and regulations.

In the next phase of this task, the Capital Markets Development (CMD) project will work with Misr for Clearing, Settlement, and Depository (MCSD) and market representatives to determine the best ways of resolving these conflicting bankruptcy provisions, enabling those conducive to the reduction of settlement risk to prevail. In this way, investor confidence will be generated and the market will be better protected against settlement risk. In a third phase of the task, draft amendments will be prepared according to the recommendations.

By 1993, the Group of Thirty on Clearing and Settlement (G-30)¹ and the Bank for International Settlements (BIS)² had identified categories of risk pertaining to the clearance and settlement of securities transactions. In Egypt, MCSD, the national central securities clearing and settlement organization, is mandated by the Capital Market Law and the forthcoming Central Depository and Central Registry Law to identify and manage such risks for the benefit of the capital market.

Central depositories must address “legal risk,” which is the risk that the risk-containment mechanisms used to guarantee the settlement of trades will not be enforced because of conflicts with other laws. Many of these other laws do not account for the needs of the capital market. In Egypt, these risk-containment mechanisms are mandated by the Capital Market Law, the forthcoming Central Depository and Central Registry Law, and MCSD’s master contract and rules, which were approved by the CMA. Legal risk is also the risk that unclear legal and regulatory provisions will create uncertainty, leading to interpretation and litigation. Such delays hinder the operations of a settlement organization in the ordinary course the services it performs for the market place.

Usually, an important source of legal risk resides in the bankruptcy law because its provisions often do not harmonize with, and have not been amended to accommodate, the needs and requirements of the capital market.

The first part of this assessment report, “Key Legal Settlement Principle,” reviews the basic principle of clearing and settlement in mature securities markets. The second section, “Risk-Containment Mechanisms,” describes means of counteracting settlement risks: those means that are most vulnerable to ordinary provisions in bankruptcy law. The third part, “Specific Legal Issues in Egypt’s Bankruptcy Law,” is based on the unanimous consensus of workshop attendees, and assesses the risks posed by provisions of Egyptian bankruptcy law. One will note that this section refers to articles of U.S. Bankruptcy and Securities Investor Protection Acts. The references are made because U.S. law is one of many good examples of how certain countries have amended their laws to fully comply with the G-30 and BIS recommendations.

¹ *Derivatives: Practices and Principle*, Washington 1993, pp. 9-25.

² *Delivery Versus Payment Systems in Securities Settlement Systems*, Basle 1992, p. 31 (“Angell Report”).

B. Key Settlement Principle

The most fundamental principle of securities clearance and settlement is that all trades must settle on the due date. MCSD has, by law, the responsibility to ensure that a trade will settle, irrespective of the failure of a financial institution or its client.

It is acknowledged worldwide that settlement failure has negative repercussions, or a “domino effect,” on all parties to a trade. A capital market that allows trades not to settle will lose the confidence of its investors and its good reputation, as will a market where trade cancellation is allowed. Independently, both the cancellation and settlement failure of a trade lead to “systemic risk.”

Systemic risk is risk that the failure of one institution to meet its settlement obligations will cause the failure other participants or financial institutions to meet their financial obligations. This is the ultimate risk. It can translate into the bankruptcy of innocent parties to a trade (a client, broker, or even a bank) and the possible collapse of a country’s financial system, with resulting repercussions on the central bank, the country’s lender of last resort. One source of system risk is legal risk, the topic of this assessment report.

C. Risk-Containment Mechanisms to Ensure Settlement

The new Central Depository and Central Registry Law will recognize and confirm the need for MCSD to assure the performance of both parties’ obligations in every securities transaction. MCSD must manage settlement and depository risks on behalf of securities market participants for the good of Egypt’s capital market. MCSD can achieve this through risk-management mechanics. There are standardized risk-containment mechanisms utilized by depositories and settlement systems around the world, generally accepted as best practices. MCSD should resort to these best practices when developing risk-containment mechanisms. They are meant to provide MCSD the collateral, or guaranteed assets, and the ability to ensure that participants’ trades are settled. MCSD cannot merely rely on promises that securities will be delivered or payment will be made, because the parties, be they the client, the participant, or its bank, may face financial difficulties and become unable to perform as required.

C1. Legal basis of risk containment

Egypt’s draft Central Depository and Central Registry Law contains several provisions relevant to containing settlement risks. These provisions are based on best practices and international standards, most of which are promoted by the G-30 and BIS. The following provisions are included in the draft law submitted to the People’s Assembly by the Ministry of Economy and Foreign Trade (MOE):

- Draft Article 51 instructs MCSD to complete the settlement transaction before the issuance of a bankruptcy judgment. Therefore, the transaction will be valid against third parties, unless the CMA suspends or cancels all or some of the participant’s transactions or upon the request of the “syndic” (the American “trustee in bankruptcy”), if the transactions were done with bad intentions.
- Draft Article 22 requires participants to enter into a contract with MCSD and to give a pledge to MCSD as a principal or on behalf of their clients (when acting as their agent).

This article allows MCSD to use the pledge as collateral to cover the settlement obligations of the defaulter to a settlement.

Therefore, the draft law requires MCSD to utilize and implement means of containing risk. It is essential to ensure that other laws will harmonize and not conflict with these new requirements.

C2. Pledge of assets, right of retention

The first means of risk containment are the pledge and the right to retain assets on deposit or standing to the credit of the defaulter. These privileges are granted by the participant to MCSD and by account holders on their securities and funds in case of non-payment or non-delivery of funds and securities at settlement time.

This allows MCSD, as a secured or preferred creditor, to either sell those securities that MCSD paid for on behalf of the defaulting buyer by utilizing the buyer's SGF contribution, or to utilize the defaulter's contribution to fund for the "buy-in" of the securities that the defaulter has not delivered. If the market value of the securities to be bought has risen above the price of the initial trade, the buy-in may cost more than the amount received by MCSD from seller.

C3. Settlement Guarantee Fund (SGF) contributions

Another risk-containment mechanism is the collection of contributions to the SGF, where the amount of collateral is calculated pursuant to a CMA-approved formula and in accordance with a periodical assessment of the settlement risks posed by the market value of the participants' transactions.

Contributions to a guarantee fund in the U.S. are exempt from refund to the trustee. 11 USC 547 and 749 and 15 USC 78 fff(b).

C4. Novation: netting and substitution

To perform efficient clearing for its participants, MCSD has to rely on the legal concept of novation. The Egyptian Civil Code already addresses novation—transforming contractual obligations into newer ones or substituting new parties for a debtor or creditor. This allows MCSD to use netting—taking all of one participant's transactions, on a given day, and transform all of them into a single, new contract. The new contract obliges and entitles the participant to deliver or receive various securities, and to pay for or receive the net amount of the total purchase prices deducted from the amount of the total sales prices of those transactions on a given day.

This serves two purposes. First, netting by novation means that funds are netted by subtracting the amount of funds owed by a participant from the amount the participant has to pay on the settlement date. In this way, it reduces the quantity of the securities to be delivered by the quantity to be received.

Second, netting by substitution allows MCSD to substitute itself or replace the participant in a trade: MCSD becomes the counterparty on each trade, or the "seller" to the buying participant and "buyer" to the selling participant. Payment of funds and delivery of securities are no longer between the participants who originally executed the transaction, but between those participants and MCSD. The combined effect of netting and substitution is that all of a participant's trade

contracts are lumped together into a single contract with various obligations, with MCSD as the counterparty.

This method is utilized by settlement systems to simplify and ensure the settlement of all trades. Without novation, a “syndic” can do “cherry picking” by not executing non-profitable transactions and executing profitable transactions—i.e., those where the market value of securities on the settlement date exceeds the price agreed to on the trade date. Without netting, a participant would be required to maintain higher cash liquidity or bank account balance in order to make various payments to its numerous counterparties, instead of having to pay a single net amount. As a result, a participant’s gross exposure would be much higher without netting if he or she were to become bankrupt. It is generally acknowledged that after netting, the amount of funds payable is reduced by at least 60 percent of the amounts that would otherwise be payable for each trade if netting had not taken place. Therefore, netting reduces the need for cash liquidity.

For example, if a broker bought LE100 million in securities on a given day and sold LE60 million, his net payment would be LE40 million. Without netting, the broker would need LE100 million in his bank account to make the payments, and then expect to be paid LE60 million. If the participant were to be declared bankrupt on that day, his debts would be LE100 million, not LE40 million. Netting thereby substantially reduces the exposure of a bankrupt debtor.

C5. Suspension or termination

MCSD should be able to suspend its clearing and settlement services or terminate its contract with a participant upon the participant’s insolvency or bankruptcy. MCSD should also be able to liquidate the defaulting participant’s position. MCSD should not be forced to accept financial risk and allow it to spread to other participants simply by continuing to provide clearing and settlement services to a bankrupt participant, except in accordance with the orderly instructions and cooperation of a syndic that fulfills the obligations.

A depository in the U.S. is generally permitted to terminate contracts with the insolvent or bankrupt participant. Participants, namely brokers, cannot engage in business after liquidation is instituted [11 USC 365, 15 USC 78, 11 USC 109].

C6. Swift action by MCSD

The settlement cycle is a short one. MCSD must ensure that participants will complete settlement in three or four days, whether securities are dematerialized or in certificate form. Because of delivery-versus-payment (DVP) requirements, all of a day's settlements must be coordinated so as to take place at a specific hour, common to all participants. In case of participant default—whether by insolvency, bankruptcy, or other reason—MCSD must have the ability to swiftly gather alternate financial resources to achieve settlement (which must be accomplished in a few hours in the worst situations and a few days in the best). It must have unencumbered access to the defaulting participant's collateral, subject only to the rules and procedures in place and agreed upon by participants in their contract with MCSD.

U.S. liquidations clearly have the objective of completing the transactions expeditiously. Moneys and securities held at the depository can be used by the depository without delay to complete settlement [11 USC 362 (b) (6)], as trades are to be honored quickly [11 USC 362 (b) (6)].

C7. Investor asset protection

Investor asset protection, while less related to clearing and settlement, is of paramount importance to investor confidence in the capital market. If a broker holding client funds or even securities, particularly in certificate form, becomes insolvent or is declared bankrupt, client assets should (1) not be used to pay the creditors of the broker, and (2) be easily identified and returned to their client owners without delay.

In the U.S., customers of brokers and securities depositories have express priority over other creditors of the broker: customers' money and securities will be returned to the customers in liquidation [15 USC 78 fff and 11 USC 748, 15 USC 78 ff].

D. Specific Issues in Egypt's Bankruptcy Law

The timing of the bankruptcy and its impact on settlement procedures is important. In some instances, the bankruptcy might be instituted after the customer has executed a trade and put up his securities or cash with a broker, but before the broker has delivered the securities or cash to MCSD. In other instances, the securities or cash may be with MCSD, but the transactions may not have been settled. Finally, the customer may have made an order, but have yet to deliver the cash or securities to the broker.

The issues raised in Egypt's Bankruptcy Law are essentially the same as those found in similar laws in most emerging and, until they were corrected recently, mature markets. Following the issues outlined above, this section examines risk-containment mechanisms and their treatment under Egyptian Bankruptcy Law.

D1. Legal basis to risk containment

Egypt's current Bankruptcy Law remains silent on circumstances relating to the liquidation of a broker and the risk-containment mechanisms used by MCSD. By contrast, U.S. bankruptcy laws (the Bankruptcy Act and the Securities Investor Protection Act) specifically and clearly provide a legal regime protecting risk-containment mechanism utilized by the clearing and settlement system.

D2. Pledge of assets, right of retention

Article 643 of the Egyptian Bankruptcy Law provides that property of the bankrupt shall not be sold during the preliminary proceedings period.

The bankruptcy judge may, upon the simple request of its syndic, permit the sale of the assets of the bankrupt, if necessary, to obtain money for spending on its current operations, or to realize positive benefits to the creditors or the bankrupt. However, this may be delayed if the judge decides to conduct a hearing on the bankruptcy.

D3. Settlement Guarantee Fund (SGF) contributions

The law does not provide that payments to the SGF are exempt from the trustee recovering them as preferential payments or fraudulent preferences. This means MCSD may not be able to use the defaulter's contributions to the SGF at the time it needs it most and for the purpose for which the SGF was created.

D4. Novation: netting and substitution

The provisions of Egyptian Bankruptcy Law on the execution of contracts permit the bankruptcy trustee to fulfill profitable contracts and to avoid unprofitable contracts. For example, Articles 589, 590, and 645 provide that the bankruptcy judge, upon the request of the trustee or the bankrupt, may continue the operation of the trading store if it is necessary for the general good or in the interest of the bankrupt or the creditors.

This allows "cherry picking," contrary to the principle that all trades, profitable or not, must be settled.

D5. Suspension or termination

Article 589 provides that the issuance of the bankruptcy declaration ruling shall fetter the hands of the bankrupt from managing and disposing of his property, unless the transaction was settled before the judge's decision. This article provides room for argument before a court over the time of registration, creating a potential source of delays.

D6. Swift action by MCSD

Article 590 provides that a bankrupt, after the bankruptcy declaration ruling is pronounced, shall not settle his debts nor receive his due rights. This clearly prevents MCSD from settling transactions of the bankrupt, directly contradicting MCSD's role and a key settlement principle.

D7. Investor asset protection

Article 616 provides that the syndic, after getting permission from the bankruptcy judge, shall pay wages, salaries, and amounts that were due to the workers of the bankruptcy before the bankruptcy ruling was issued and for thirty days thereafter. These amounts must be paid out of the monies and assets realized from the property of the bankrupt, regardless of the existence of other debts. If the bankruptcy trustee does not have money necessary to settle these debts, settlement shall be made from the first money entering the bankruptcy, even if there are other debts preceding them because of a higher-ranking lien.

Article 618 provides that a lien, prescribed for the government on all kinds of taxes, shall only comprise the tax due from the bankrupt for the two years prior to the issuing of the bankruptcy declaration ruling.

Article 619 provides that the bankruptcy judge may, upon the proposal of its syndic, order using the first money entering the bankruptcy in settling the rights of the creditors who have a lien on the movables of the bankrupt.

E. Workshop Consensus

At the Bankruptcy Workshop, the salient points of U.S. bankruptcy laws pertaining to capital markets were reviewed, the seven important key issues of clearing and settlement under bankruptcy laws were described, and the concept of legal risk was explained.

Following the presentation, these seven questions were asked to the workshop participants:

Is the Egyptian Bankruptcy Law sufficiently clear to ensure that:

1. The customer has priority over creditors (priority of claim)?
1. Customer money and securities held by the broker are returned to the customers (segregated assets)?
1. SGF contributions are not preferential payments or fraudulent preferences that can be voided by the syndic (exempt contributions)?
1. Money and securities pledged to MCSD can be used by MCSD without delay to complete settlement (no stay of proceedings)?
1. Netting of cash and securities is binding on the "syndic" (no cherry picking)?
1. Substitution of MCSD to defaulting buyer or seller is binding on the "syndic" (novation)?
1. MCSD can suspend or terminate its service contract with a defaulting participant (termination of contract)?

As anticipated, the workshop participants unanimously answered all seven questions in the negative. The answers indicated the need to recommend appropriate amendments to the law.

F. Assessment

Egyptian bankruptcy law is silent or ambiguous on several key issues that are crucial to the reduction of settlement risks. These are all addressed in U.S. liquidation provisions. While the

draft Central Depository and Central Registry Law clearly states that MCSD must complete the transaction, the law also states that, under certain circumstances, the bankruptcy syndic can stop the completion of the transaction.

This raises serious doubt in the capital market as to whether the transaction will be completed because the syndic can intervene in, and the law may interfere with, the normal operations of the settlement system managed by MCSD.

Second, the draft Central Depository and Central Registry Law provides for requiring participants to pledge collateral to MCSD. However, it is questionable whether the pledge will be honored in a bankruptcy proceeding. What would be necessary for the judge and trustee to honor this pledge remains to be determined. In addition, the law is silent on the timing of the honoring of the pledge. It is important to settle the transactions quickly. This is especially important if the securities or cash are still with the broker when the bankruptcy is instituted.

Third, assuming MCSD does complete the transaction—notwithstanding a bankruptcy or customer claims against the broker for some of its securities or cash—the draft Central Depository and Central Registry Law suggests that MCSD has a lien on the property of the bankrupt needed to complete the transaction. However, the draft law does not deal with a situation in which MCSD is not involved with closing the transaction but rather with asserting a claim in the bankruptcy. In this situation, it is clear that the customer and MCSD do not have priority positions over other creditors. Arguably, the customer could take the position that some of the property is not the property of the bankrupt but instead is the property of the customer. However, this is not clearly set forth in the law. Also, the law is not clear that MCSD would have a subrogated claim for a customer's loss that is reimbursed by MCSD.

Finally, the Bankruptcy Law does not clearly permit MCSD to terminate its contracts with the bankrupt broker. There should be a provision in the law permitting such a termination.

It must be noted that, under current Egyptian practice, securities are never registered in the name of the broker, and that brokers put client cash in separate bank accounts rather than their own. While these protections are helpful, they do not resolve the overall problems identified in this assessment.

Broker liquidations are rare in the U.S. This is the case in Egypt, where there has never been such a bankruptcy and the present bankruptcy law does not center on such bankruptcies. Nevertheless, the recommendations in this report will provide protection against such a possibility. They will also provide additional confidence to investors, by reducing the risk that they will be exposed to the financial difficulties of their financial intermediaries. Because these recommendations are in place in the U.S., the settlement system is protected by bankruptcy laws as a preferred creditor and the market does not feel any impact of a default when a bankruptcy, however rare, occurs.

G. Conclusion

There was clear and definite consensus among workshop participants that Egyptian bankruptcy law requires modification along the lines recommended by the G-30. These modifications should be designed to eliminate existing legal risk and make the Egyptian legal regime consistent with its capital market.

Modifying the law will require developing recommendations and drafting suggested amendments. The Bankruptcy Law was approved recently and the draft Central Depository and Central Registry Law is currently before the People's Assembly. Therefore, this report recommends that modifications to bankruptcy provisions should be proposed as part of the new Capital Market Law, currently being drafted by the MOE.

It is important to stress that the amendments are not required to serve the interests of MCSD as an institution, but rather for the sake of MCSD's role as the manager of clearing and settlement risks in Egypt. None of the recommendations or changes to the law would benefit MCSD financially in any way. For example, MCSD would not have better rights for non-settlement debts due it by an insolvent or bankrupt participants, such as service fees, than any ordinary creditor.

The legislative adjustments are sought exclusively to harmonize bankruptcy law with capital market legislation, ensuring that trades settle when a participant is insolvent or bankrupt. Once MCSD has fulfilled the settlement obligations of a bankrupt or insolvent participant using the participant's collateral, any remaining assets and MCSD itself are outside the scope of protection that the proposed amendments would grant.

APPENDIX A

Workshop Participants and Agenda

MCSD Legal Workshop on the Capital Market and Bankruptcy Issues

Date: Wednesday, March 29, 2000

Time: 9:30 to 15:00

Place: CMD meeting room of the Capital Market Development Project
20 Aisha el Taimoriya, 2nd Floor—Garden City

Speaker: Marc E. Albert, Esq., bankruptcy law practitioner, Washington, DC

In attendance:

Ashraf Shoukry	Legal Advisor, MOE
Abdel Azeem El Shehewi	CBE
Nassrah Mahmoud Taha	CBE
Samia Abdel Wahab Turkey	CBE
Amr El Nokaly	Citibank
Hatem Badr	Citibank
Sherif Bedewy	Citibank
Assem Shahab	Citibank
Mohamed Abdel Salam	MCSD
Ashraf El Kaadie	MCSD
Reda Farahat	MCSD
Ahmed Akram Helmi	MCSD
Reham Gamal Mahmoud	MCSD, (Operation)
Karim Adel Kamel	Adel Kamel Law Office
Raouf Kedwani	Misr America Bank
Bassel Gamal Aly	CIB
Rania Zayed	Fortune Consulting
Assem Ragab	Fortune Consulting
Mark Prothero	EBB
Omayma Youssry	EBB
Tamer Erfan	Al Ahly Real Estate Dev. Co.
Gada Kortom	Shalakany Law Office
Yasmine El Gharabawy	Shalakany Law Office
François Pépin	CMD
Michael Porter	CMD
Neffertiti Tosson	CMD

Invitees not in attendance:

Dr. Ziad Bahaa-Eldin	Minister of Economy's Office
Abdel Azeem El Shehewi	CBE
Mohamed Gamel El Din	CBE
Ahmed Sabri	National Center for Judicial Studies
Mohamed Kamel	CASE
Bassel Gamal Aly	CIB
Hesham Abdel Fattah	CIB

Agenda

1. Purpose of this Workshop
1. Presentation on U.S. Bankruptcy Law addressing capital market and Securities Investor Protection Law: relationships and differences
1. Issues in Egyptian law.
1. Feedback discussion
1. Next steps

APPENDIX B

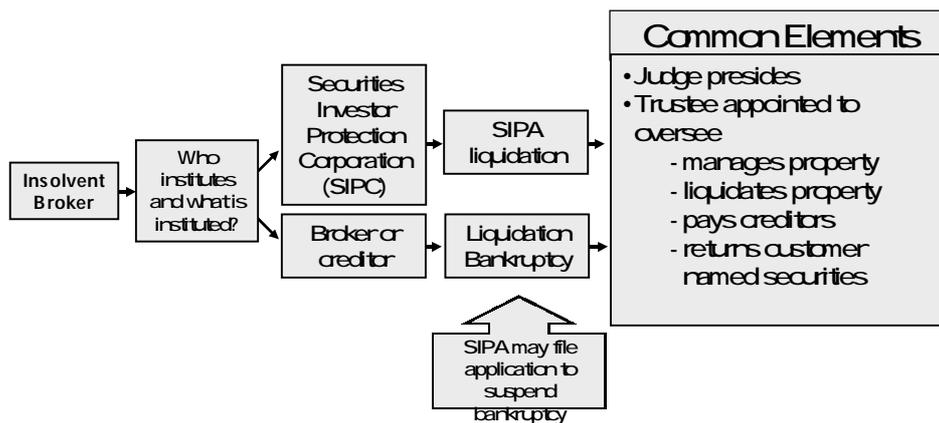
Workshop Presentation Slides

MCS D Legal Workshops



Capital Markets and Bankruptcy Issues
29 March 2000

US Bankruptcy Procedures



Elements Unique to SIPA Liquidation

- ◆ non named securities and cash to customers receives financial help from SIPC
- ◆ trades generally honored
- ◆ transfer accounts to other brokers
- ◆ all customers share proportionally the same
- ◆ customer claims fixed as of bankruptcy filing
- ◆ however, customer at risk until securities delivered

Elements Unique to Liquidation Bankruptcy

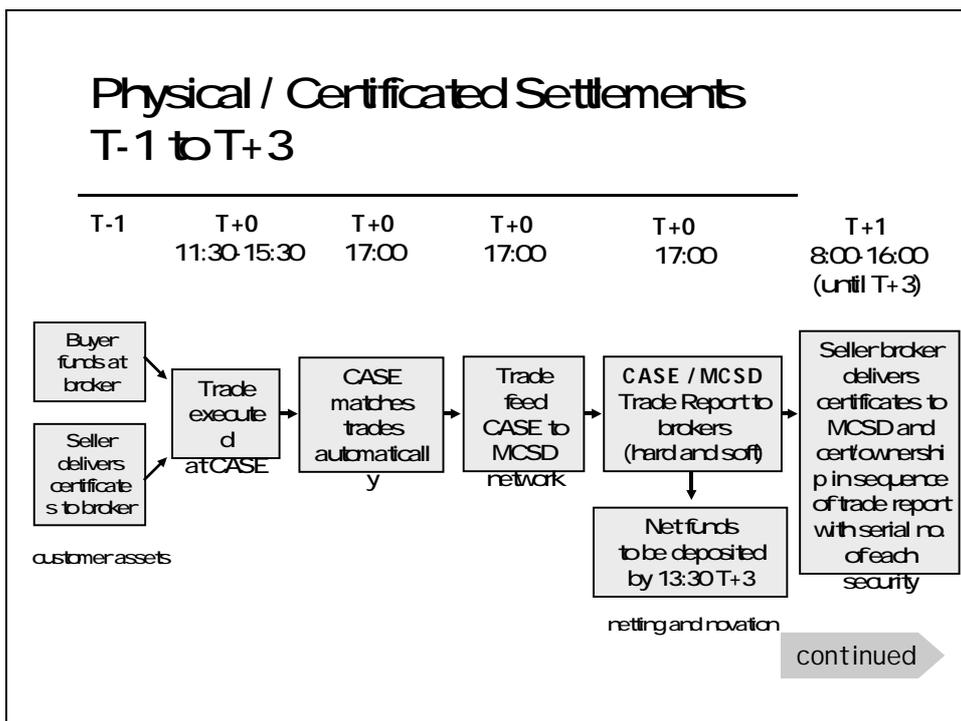
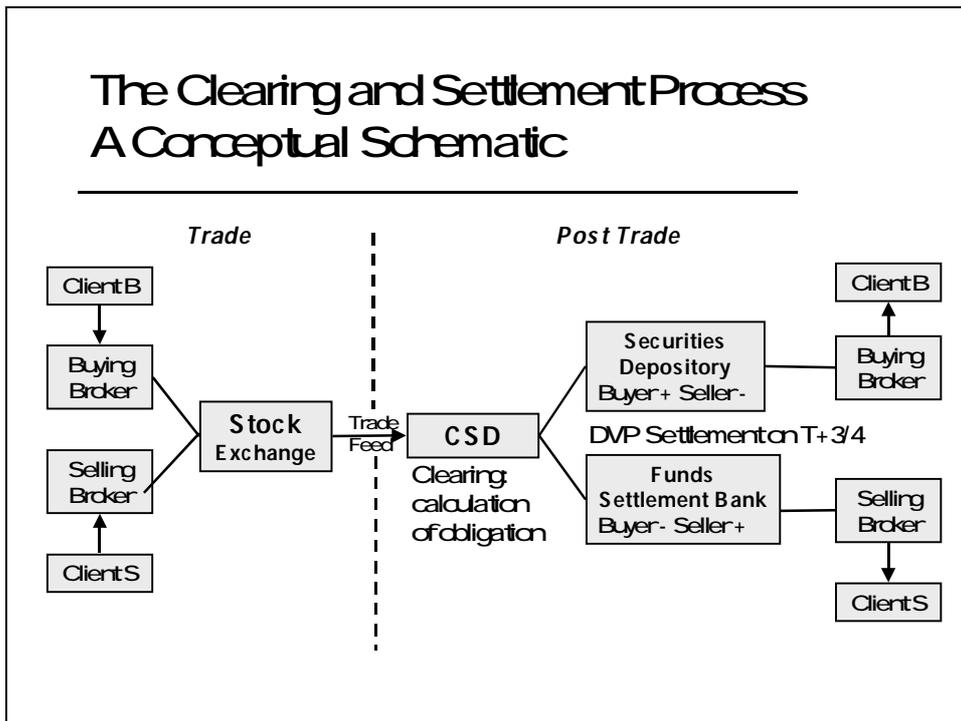
- ◆ customer property liquidated to cash to return to customers
- ◆ only honors trades if in the trustee's judgment makes sense
- ◆ all customers share proportionally the same
- ◆ customer claims fixed as of bankruptcy filing

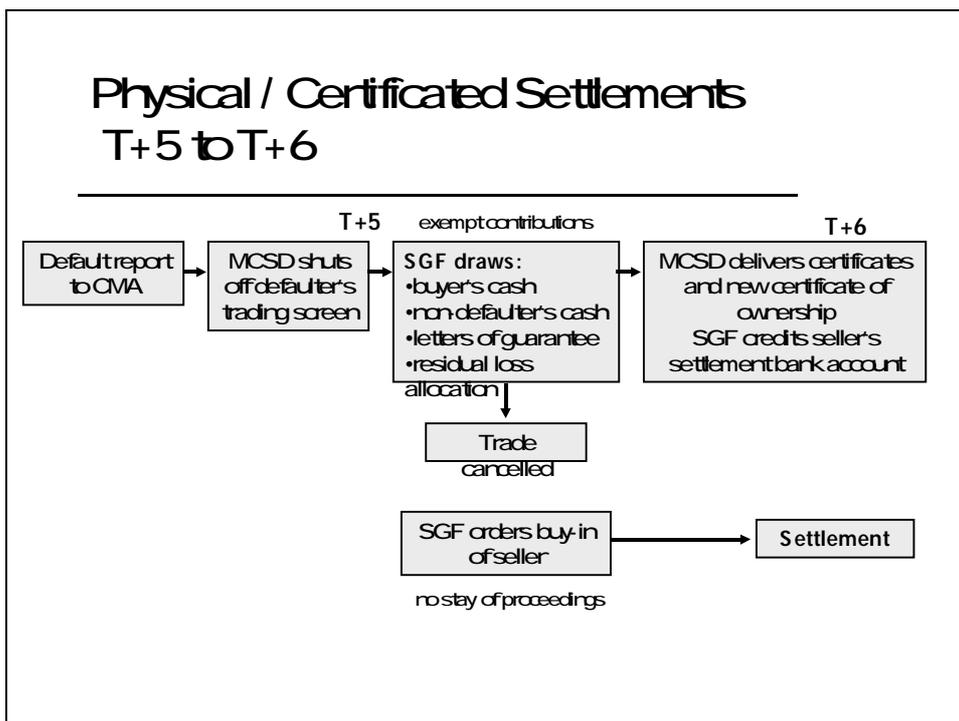
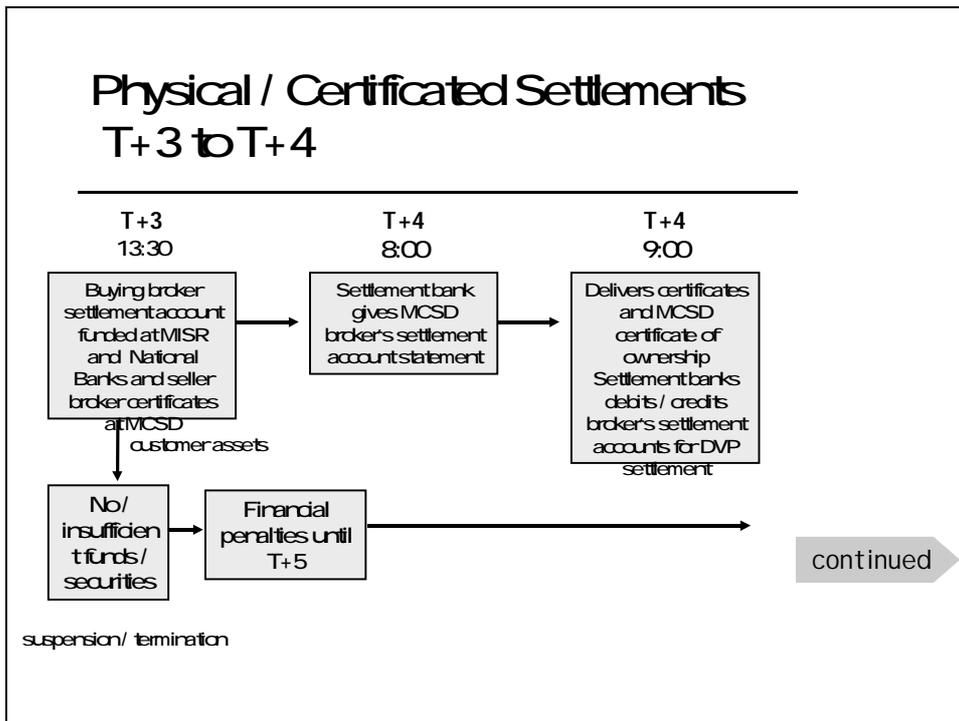
Key Capital market Issues Addressed in SIPA and/or Liquidation Bankruptcy

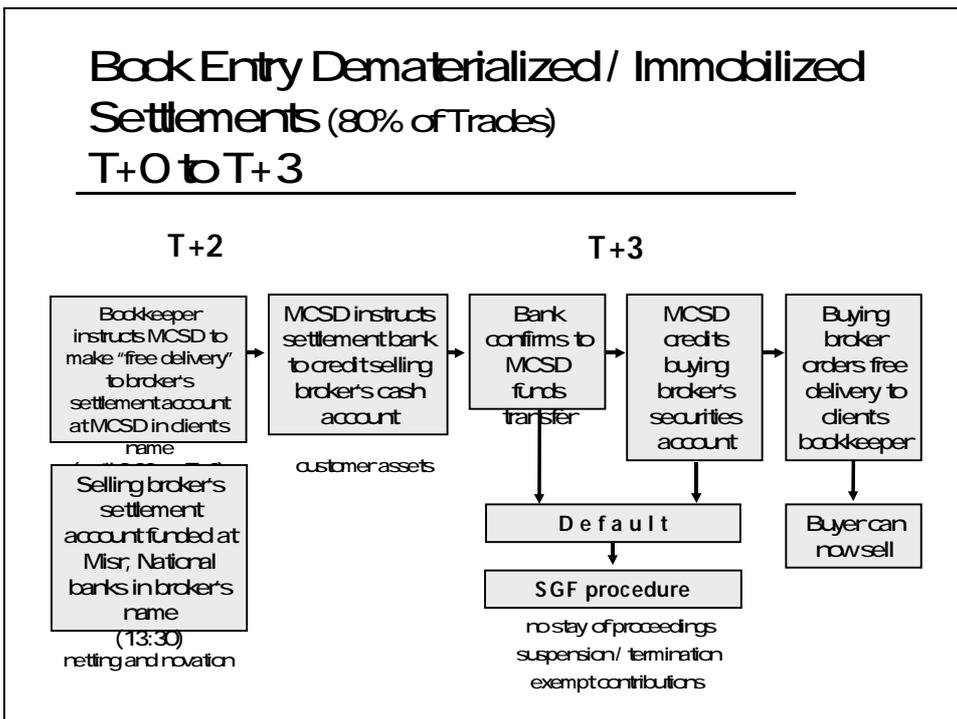
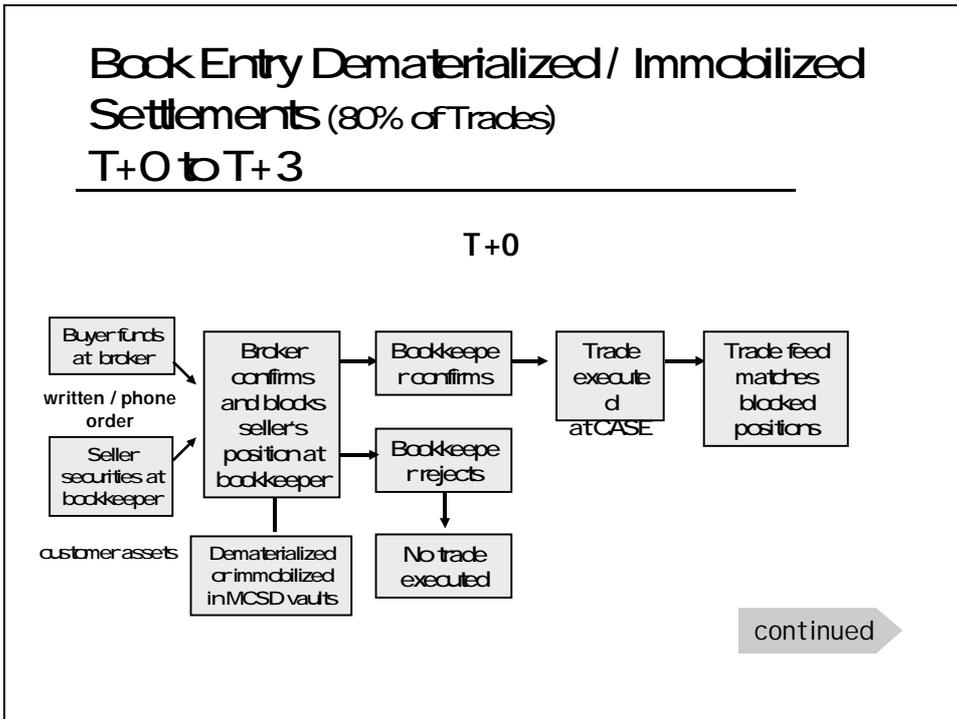
1. Customers have priority over creditors.
15 USC 78 fff and 11 USC 748
2. Customers' money and securities will be returned to the customers in a SIPA liquidation.
15 USC 78 fff
3. Fund contributions are not preferential payments or fraudulent transfers that can be avoided by the Trustee.
11 USC 547 and 749, and 15 USC 78 fff (6)

Key Capital market Issues Addressed in SIPA and/or Liquidation Bankruptcy (continued)

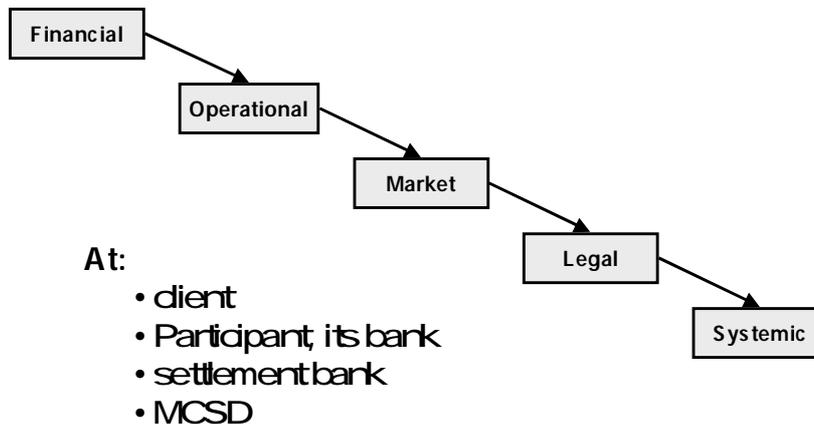
4. Money and securities with Depository can be used by the Depository without delay to complete settlement. 11 USC 362 (b) (6)
5. Trades honored in SIPA. In SIPA, trades are to be completed quickly. 15 USC 78 fff
6. Depository may terminate contracts with bankrupt broker. Broker can not engage in business after liquidation is instituted.
11 USC 365 (c), 15 USC 78 and 11 USC 109







The Five Risks



Fundamental Risk Concerns of MCSD

The Legal Risk

- ◆ The provisions of Capital Market Law, New Depository Law, the contract and rules of MCSD are not enforceable due to a lack of legal basis or contradicting provisions.
- ◆ unclear or uncertain provisions leading to litigation (delays, costs, unpredictability)

The 7 Main Legal Issues of MCSD

Is the law sufficiently clear to ensure that...?

1. customer has priority over creditors
(priority of claim)
2. customer money and securities are returned to the customers (segregated assets)
3. SGF contributions are not preferential payments or fraudulent preferences that can be voided by the syndic (exempt contributions)

The 7 Main Legal Issues of MCSD (continued)

4. money and securities pledged to MCSD can be used by MCSD without delay to complete settlement
(no stay of proceedings)
5. netting of cash and securities is binding
(no cherry picking)
6. substitution of MCSD to defaulting buyer or seller is binding (novation)
7. MCSD can suspend or terminate its service contract with a defaulting participant (termination of contract)